



2007

Unwinding Unwinding

David M. Hasen

Santa Clara University School of Law, david.hasen@colorado.edu

Follow this and additional works at: <http://digitalcommons.law.scu.edu/facpubs>

Recommended Citation

57 Emory L.J. 871

This Article is brought to you for free and open access by the Faculty Scholarship at Santa Clara Law Digital Commons. It has been accepted for inclusion in Faculty Publications by an authorized administrator of Santa Clara Law Digital Commons. For more information, please contact sculawlibrarian@gmail.com.

UNWINDING UNWINDING

David Hasen*

“Unwinding” is a common, if not ubiquitous, feature of tax practice. In a successful unwind, parties to a prior transaction or arrangement back out of it by means of a later transaction and are treated for tax purposes as having engaged in no transactions at all. In a failed unwind, the parties undertake the later transaction, but it is not treated as nullifying the effects of the first transaction; rather, two separate transactions are deemed to have taken place, each with its own tax consequences.

This Article develops the first unified theoretical framework for analyzing tax unwinding. It also provides an organizing principle applicable to other kinds of corrective action that individuals or the government may undertake in the income tax context. These types include equitable recoupment, the tax benefit rule, and the claim of right doctrine. Each involves resolution of a different kind of excusable inconsistency in taxpayer or, sometimes, government conduct. In the case of unwinding, the inconsistency arises between the taxpayer’s understanding of the circumstances in which she acts and the circumstances as they actually are; it concerns the possible efficacy of a chosen action to realize an end the taxpayer seeks to achieve. In some such cases, unwinding relief may be appropriate, but it is usually appropriate only where the relevant taxes are themselves transactionally based. In the non-transactional tax context, more stringent requirements apply to the nature of the taxpayer’s error, and administrative considerations militate against an expansive unwinding doctrine.

* Assistant Professor of Law, University of Michigan. I thank Reuven Avi-Yonah, Evan Caminker, Steve Croley, Diane Eisenberg, Barbara Fried, Joel Hasen, Don Herzog, Stephen Lind, Kyle Logue, Don Regan and participants at various colloquia for helpful comments and criticisms. Victor Fleischer suggested the title. The Cook Endowment at the University of Michigan Law School provided research support for this Article. I remain solely responsible for any errors.

INTRODUCTION	873
I. UNWINDING	877
A. <i>Unwinding in General</i>	877
B. <i>IRS and Judicial Treatment of Unwinds</i>	879
1. <i>Commercial Unwinds</i>	879
a. <i>Rescissions</i>	880
b. <i>Retroactive Modifications</i>	884
2. <i>Reformations</i>	885
3. <i>Cancellation of a Gift</i>	892
C. <i>Summary</i>	894
II. UNWINDING AND ERRORS IN GENERAL	895
A. <i>Conceptual Underpinnings of Unwinding</i>	895
1. <i>Transactional Versus Income Taxes</i>	895
2. <i>Why the Income Tax Is Not a Tax on Transactions</i>	897
a. <i>Haig-Simmons Income Concept</i>	897
b. <i>"When" Versus "Whether"</i>	899
3. <i>Unwinding Under a Non-Transactional Tax</i>	902
B. <i>Tax Errors</i>	905
1. <i>Logical Error—Equitable Recoupment/Mitigation</i>	907
2. <i>Factual Error—Tax Benefit Rule/Claim of Right</i>	910
a. <i>Tax Benefit Rule</i>	910
b. <i>Claim of Right</i>	916
c. <i>Observations on the TBR and Claim of Right</i>	918
3. <i>Purposive Error—Contextual Mistake</i>	919
C. <i>Observations</i>	921
D. <i>"Reasonable" Excuse Generally</i>	929
III. UNWINDING IN PRACTICE	932
A. <i>Substantive Issues</i>	933
1. <i>Mistake of Law</i>	933
2. <i>Tax Motivation</i>	936
B. <i>Tax Administration and the Problem of Government</i> <i>"Whipsaw"</i>	940
CONCLUSION	942

INTRODUCTION

The problem of “unwinding,” or nullifying, transactions has bedeviled the tax law from its inception. Simply stated, it is as follows: Under what circumstances should taxpayers be permitted to undo the tax consequences of previously consummated transactions, and under what circumstances not? Put more concretely, when will a transaction that purports to negate or unwind a prior transaction be respected as such, and when will it be treated as a separate transaction with its own separate tax consequences? In the former case, nothing has happened for tax purposes. In the latter case, two things have happened.

A simple example illustrates the issue.¹ Suppose that *Seller* (*S*) sells *Blackacre* to *Buyer* (*B*) for cash at time t_0 . Sometime later, at time t_1 , the parties decide they want to “cancel” the sale and return themselves to the status quo ante. At that time, *B* reconveys *Blackacre* to *S*, and *S* transfers an amount of cash equal to the sales price (possibly plus interest) to *B*. From the parties’ perspectives, the second transaction is intended as an unwind of the first, designed to render the original sale as far as possible a nullity—something that, in essence, never happened. From the perspective of the tax law, much hangs on whether effect is given to this intention. If the reconveyance is treated as an unwind, then there are no income tax consequences to the two transactions. *S* recognizes no gain or loss, takes her original basis in *Blackacre*, and tacks her holding period; *B* likewise recognizes no gain or loss, receiving her money back. If the reconveyance is not respected as an unwind, then two sale transactions have occurred, the first at t_0 , and a second at t_1 , each with its own tax consequences.²

The sale-cancellation case represents a common type of unwind, but it is by no means the only one. Other recurring unwind situations include retroactive modifications of divorce decrees,³ cancellations of dividends,⁴ and revocations

¹ This example is the discussion model used in Sheldon I. Banoff’s article, *Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud?*, 62 TAXES 942, 944 (1984) [hereinafter Banoff, *Unwinding*].

² Under the facts of the example, the income tax consequences to *B* are likely to be less drastic than to *S* under any scenario. *B* could recognize gain on the sale if the transaction were not unwound if, for example, *B* had taken depreciation deductions on the property, but if the transaction were unwound, *B* would have to reverse the deductions anyway. Note that other taxes may be at issue as well, such as land transfer or property taxes.

³ See, e.g., Rev. Rul. 71-416, 1971-2 C.B. 83 (giving retroactive effect to modification *nunc pro tunc* of a divorce decree two years after the decree was entered, where the purpose of the modification was to correct a computational error).

of tax elections,⁵ among a host of others. Moreover, although the focus here is on the tax context, the problem of unwinds is ubiquitous throughout the law, and indeed beyond. For example, the transactions between *B* and *S* may raise the question of whether the law will view *B* as an owner in the chain of title, potentially liable for environmental or other torts that occurred on the property during or before the time that *B* held it.⁶ More generally, countless transactions purport to operate as cancellations of prior transactions or arrangements, and in principle the same questions arise in each case. Is the reconveyance of property to a bankruptcy estate the reversal of a preference or the separate transfer to it of "new value"?⁷ Should the termination of a marriage be treated as an annulment or a divorce? Is the retraction of a promise reprehensible renegeing or an excusable change of course? In each case, what is sought is some principle by which to determine when an effort to nullify a prior transaction or arrangement will or should be respected, and when not.

In the tax context, the availability of unwind treatment can bear significantly on the parties' conduct, both before they enter into the first transaction and as they consider any possible effort to unwind it through a second one. The parties may structure their initial transaction to keep the possibility of unwinding open, and they may alter their conduct after the first transaction to make sure that the second transaction does, or in some cases that it does not, qualify as an unwind. The dollars involved may be very large in any given case, and there is no doubt that in the aggregate a significant amount of tax revenue is at stake.⁸ Further, the efficiency costs of planning for unwinding and of doing it are likely to be substantial.⁹

⁴ Compare, e.g., *Hanco Distrib., Inc. v. United States*, 32 A.F.T.R.2d 73-5485 (D. Utah 1973) (not officially reported) (according unwind treatment to repayment of dividend made pursuant to scrivener's error), with, e.g., Rev. Rul. 75-375, 1975-2 C.B. 266 (refusing to accord unwinding effect to voluntary repayment of a dividend). See generally Sheldon I. Banoff, *IRS Disregards Taxpayer's Attempt to Unwind Dividend*, 95 J. TAX'N 188 (2001) (discussing dividend repayment authorities).

⁵ See, e.g., I.R.C. § 1362(f) (2006) (permitting waiver of inadvertent termination of S corporation status in certain circumstances).

⁶ See Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) § 107, 42 U.S.C. § 9607 (2006); see also *U.S. Postal Serv. v. Phelps Dodge Ref. Corp.*, 1997 WL 1068674, at *1 (E.D.N.Y. July 9, 1997) (noting one party's concern that it would be exposed to CERCLA liability if a judicial cancellation of a prior sale were effected as a reconveyance rather than a rescission of the original transaction).

⁷ See, e.g., I.R.S. Priv. Ltr. Rul. 81-49-043 (Sept. 9, 1981) (holding that the transfer and re-transfer of property treated as, respectively, a fraudulent conveyance and nullification thereof for state law purposes constituted two separate transactions as between the parties for tax purposes).

⁸ An informal survey that the author conducted of approximately fifteen tax practitioners at large law firms and accounting firms suggests that dealing with efforts to unwind occupies one to two percent of the

Despite the ubiquity and significance of the unwinding problem, no general framework for the analysis of unwinds exists. In the tax context, the authorities have tended to evaluate unwind situations in ways that depend upon the type of transaction involved or on the presence or absence of putatively licit or illicit motives, rather than on the basis of features common to unwinds generally.¹⁰ As a result, in different areas the law has developed in ways that are hard to reconcile and that do not reflect any consistent theoretical approach or policy.¹¹ The reversal of a sale may be given unwind effect, but a contractual reformation is unlikely to receive the same treatment.¹² Marital annulments may undo the marriage for filing purposes,¹³ but not for purposes of post-annulment transfers of property between the parties.¹⁴ A tax-motivated trust reformation¹⁵ may be denied unwind treatment, whereas a tax-motivated contractual rescission may not.¹⁶ In these and other cases, it is hard to identify a principle or policy goal that is consistently served by the different rules.

A paucity of academic commentary parallels the lack of coherence in the reported cases and rulings. There appears to be no sustained theoretical treatment—normative or positive—of the unwind phenomenon, despite the frequency with which it arises in practice. The only comprehensive discussion in the tax area is Sheldon Banoff's exhaustive, though now dated, article on the subject,¹⁷ which identifies general considerations that the IRS and the courts

typical tax attorney's billable hours. Estimates of the total dollars involved are not available. Another indicator of the significance of the unwinding issue is the fact that it is frequently the subject of continuing legal education seminars.

⁹ These costs may include inefficient structuring of the initial deal, inefficient conduct after it to keep the possibility of unwinding open, and, of course, inefficiently ensuring unwind treatment, or ensuring it does not apply, in connection with a second transaction. For a discussion of the efficiency losses associated with tax planning, see generally David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 (1999) [hereinafter Weisbach, *Line Drawing*].

¹⁰ Banoff, *Unwinding*, *passim*.

¹¹ See *id.* at 993 ("To say the least, the state of the tax law with respect to the ability to retroactively unwind transactions is somewhat confusing . . ."). See *infra* Part I for a review of authorities.

¹² Compare, e.g., Rev. Rul. 93-79, 1993-2 C.B. 269 (holding generally that unwind treatment does not apply to judicial reformations of a "completed transaction"), with, e.g., Rev. Rul. 80-58, 1980-1 C.B. 1981 (Situation 1) (permitting unwind of sales rescission where the rescission occurred in the same year as the original sale). See also *infra* Part I.

¹³ See Rev. Rul. 76-255, 1976-2 C.B. 40.

¹⁴ See Temp. Treas. Reg. § 1.1041-1T(b), Q&A (8) (1984).

¹⁵ See, e.g., *Estate of La Meres v. Comm'r*, 98 T.C. 294, 311-12 (1992).

¹⁶ See, e.g., I.R.S. Priv. Ltr. Rul. 98-29-044 (July 17, 1998) (treating a tax-motivated rescission of a stock transfer that defeated S corporation status as an unwind).

¹⁷ Banoff, *Unwinding*, *supra* note 1. More recently Banoff has published a detailed discussion of unwinding in the contractual rescission context. See Sheldon I. Banoff, *New IRS Rulings Approve Rescission Transactions that Change an Entity's Tax Status*, 105 J. TAX'N 5 (2006) [hereinafter Banoff, *Rescission*].

have applied to putative unwinds and provides an overview of the authorities. It does not develop a theory of unwinding. Similarly, an array of shorter articles and commentary reviewing the law in particular settings is available, but these discussions also do not attempt any theoretical analysis.¹⁸

The purpose of this Article is to bring such a theoretical perspective to bear on the problem. The more synoptic view adopted here suggests that the availability of unwind treatment in any given case should hinge in the first instance on the type of tax involved. In the excise tax context, and more generally in any setting in which the event "itself" is what is subject to tax, unwinding generally should be available if the second transaction that "undoes" the first occurs. In the income tax context, the issues are considerably murkier, because the existence of the thing that is taxed—income—does not depend upon the fact of a transaction. Rather, the transaction provides the occasion for imposing the tax now rather than at some other time; the income (or loss), however, will generally be taken into account eventually.¹⁹ Hence, the availability of unwind treatment should not depend, even in the abstract, on the mere return to the status quo ante, because such a return does not mean that nothing giving rise to a tax has occurred. Instead, some additional set of considerations ought to apply to determine whether unwind treatment is appropriate in such a case, even if the second transaction effects a thoroughgoing return to the status quo ante.

In this Article, I argue that the additional considerations are analogous to those that apply in related circumstances involving different forms of error correction. That is, unwinding should be understood as one of a class of equitable remedies made available for various kinds of taxpayer error, each of which involves a kind of "unwinding."²⁰ This perspective offers two advantages. In the first place, it permits the development of a systematic

¹⁸ See, e.g., Note, *Effect of State Court Decisions on Federal Tax Liability of Parties to the State Proceedings*, 59 HARV. L. REV. 948 (1946); Banoff, *Rescission*, *supra* note 17; Robert Willens, *Rescission Doctrine Can Make a Transaction Disappear*, 112 TAX NOTES 801 (2006). Like Banoff's original article, most of these commentaries focus on the factors that a court or the IRS is likely to find significant in determining whether unwinding treatment applies in a particular factual setting. Most recently, David Schnabel has written on the consequences of attempts to unwind in the rescission, reformation and check-the-box contexts. See David H. Schnabel, *Revisionist History: Retroactive Federal Tax Planning*, 60 TAX LAW. 685 (2007).

¹⁹ A major exception to the rule is for property passed at death. Under I.R.C. § 1014, the basis of property held at death is set to its fair market value.

²⁰ I thank Barbara Fried for insight on the relationship of unwinding to remedies for other kinds of tax errors.

framework for the analysis of unwinding that eschews the ad hoc nature of the inquiry under current law. Secondly, and perhaps more importantly, it brings some order to the similarly unsystematic area of equitable remedies in tax.

Part I describes the generic features of unwinds and presents an overview of some of the legal authorities, focusing on several recurring cases. Part II develops a more systematic understanding of unwinding and situates unwinding in the larger framework of taxpayer and governmental errors and the remedies available for them. Part III examines practical considerations relevant to determining whether unwinding should be available in the context of both transactional and non-transactional taxes. A short conclusion follows.

I. UNWINDING

A. *Unwinding in General*

According unwind treatment to a transaction that “undoes” a previously consummated transaction nullifies the tax effects of both; in essence, the person or persons involved in the earlier transaction are treated as though they had never engaged in either.²¹ For clarity, I use the term *reversal* to refer to the later transaction that factually undoes the first transaction in whole or part, and the term *unwind* to refer to the legal conclusion, which may or may not apply, that the reversal operates as a cancellation, for tax purposes, of the first transaction to the extent of the reversal. Thus, while the power to reverse a transaction ordinarily lies with one or more of the parties to it, the status of the reversal as an unwind depends upon legal principles. So defined, the general question is whether the tax law regards a reversal as an unwind.²² For example, the reconveyance of *Blackacre* from *B* to *S*²³ is a reversal, and the tax law’s treatment of the reconveyance as a nullification of the sale would be an unwind. Had *B* and *S* agreed that *B* would keep 70% of *Blackacre* but return the other 30%, the reconveyance likewise might be a reversal as to that portion,

²¹ Unwinds may nullify prior arrangements, rather than just transactions. Examples include marriage annulments and revocations of tax elections. For simplicity, I will generally speak of transactions, but the term “arrangement” should also be understood where appropriate.

²² Thus, many transactions will be reversals of prior transactions, but not all of them will be given unwind effect. That said, many reversals will be engaged in only if the parties believe that the reversal will be accorded unwind effect. Clarity in the law, then, would be of particular value to taxpayers whose reversal decision is motivated by the tax consequences.

²³ See *supra* text accompanying notes 1–2.

but under the relevant authorities, it is unlikely that the transaction would be unwound to the extent of the reconveyance.²⁴

At the outset it is important to distinguish a reversal from the more generic concept of a return to the status quo ante. In the case of a reversal, the parties return to the status quo ante because an un hoped-for event or condition occurs or becomes manifest as a result of or following the first transaction. In the absence of such an event or condition, there would be no plausible reason to treat the second transaction as “undoing” the first one. Rather, there would be two transactions, each with its own purpose. For example, the ordinary termination of a land lease is not a reversal, even though the termination re-vests possession in the owner of the fee. The purpose of the two transactions is to vest possession in the lessee for the lease term, but not for longer. Similarly, a shareholder’s independent decision to reinvest a dividend is not an unwind, even though the investment of the dividend returns the dividend to corporate solution.²⁵ These and similar situations do not involve any effort to nullify the first transaction on account of its failure to achieve its intended purpose.

Table 1 presents a preliminary characterization of the generic form of an unwind.²⁶

²⁴ See, e.g., Rev. Rul. 80-58, 1980-1 C.B. 181 (holding that unwind treatment requires restoration of status quo ante); see also *infra* Part I.B (discussing authorities dealing with these situations).

²⁵ See *Crellin's Estate v. Comm'r*, 203 F.2d 812, 815 (9th Cir. 1953) (declining to unwind dividend distribution following voluntary reinvestment by stockholders).

²⁶ The characterization is refined *infra* Part II.

Table 1: Unwinding

1.	t_0 :	<i>A and B enter into Transaction 1.</i>
2.	t_1 :	<i>Event or Condition of a particular kind occurs or is discovered that thwarts part or all of the purpose of Transaction 1 from the outset.</i>
3.	t_2 :	<i>As a result of Event or Condition, A and B reverse, in whole or part, Transaction 1 by entering into Transaction 2.</i>
4. result		Transaction 2 is credited as an unwind, so that the transactions (or Transaction 2 and some part of Transaction 1) are disregarded for tax purposes.

As suggested above, the situations in which parties may seek to have a transaction unwound are innumerable.²⁷ They include not only cases in which the parties are restored fully to the status quo ante but also retroactive contractual modifications, purchase price adjustments, and other arrangements in which the parties seek to cancel only part of the original transaction, perhaps even substituting new terms in place of the cancelled terms.²⁸ Each case, however, bears the generic features set forth in *Table 1*.

B. IRS and Judicial Treatment of Unwinds

Unwind situations are part of the standard fare of most tax practices, and, not surprisingly, the authorities dealing with them are numerous. In order to give a flavor for the issues they present and a sense of how the courts and the IRS have dealt with them, this section reviews the law in three generic unwind situations: dispositions for value, or commercial unwinds; trust reformations; and gifts. As will become evident, it is difficult if not impossible to draw out a set of consistent principles from these examples.

1. Commercial Unwinds

The examples discussed here involve reversals of transactions or arrangements entered into at arm's length, in an exchange of value for value. Because these cases involve parties dealing in a commercial context, at the

²⁷ See *supra* notes 3–9 and accompanying text.

²⁸ See Banoff, *Unwinding*, *supra* note 1, at 942–43 (listing types of unwinds).

federal level they overwhelmingly raise the unwind question in the income tax context. As a general matter, two types of unwinds may arise in this setting. Commonly, the parties may attempt to back out of a transaction entirely through some sort of rescission. Here, the question is whether restoration of the parties to the prior status quo is sufficient to permit them to unwind. Other transactions involve retroactive modifications to previously consummated transactions. In these cases, the transaction itself is not cancelled; rather a portion of it is, and, in many instances, new terms are substituted for the cancelled terms. Modifications may be conceptually more complex since they can consist of both a reversal and the adoption of new terms.

a. Rescissions

The principal authorities governing the income tax treatment of rescissions are *Penn v. Robertson*²⁹ and Revenue Ruling 80-58.³⁰ In *Penn*, the taxpayer, Penn, participated in an employer-sponsored employee stock benefit plan in 1930 and 1931. As a result of shareholder suits, the plan was rescinded in 1931 for all participants who consented to relinquish their rights under the plan. Consenting participants received back in that year all contributions they had previously made. Penn consented, and the government sought to tax the amounts returned to him. The Fourth Circuit held that amounts received in respect of 1931 contributions were treated as though they were never contributed in the first place, but it refused to accord the same treatment to amounts received in respect of 1930 contributions. As to the 1930 contributions, the court ruled that the annual accounting principle prevented recomputation of the taxpayer's 1930 income after the close of the tax year.³¹ The annual accounting principle "requires the determination of income at the close of the taxable year without regard to the effect of subsequent events."³²

In Revenue Ruling 80-58, the IRS applied the *Penn* framework to two situations involving *Seller* and *Buyer*, who were each calendar-year taxpayers. In both situations, *Seller* conveyed real property to *Buyer* in February 1978 for cash pursuant to a contract that permitted reconveyance of the property if

²⁹ 115 F.2d 167 (4th Cir. 1940).

³⁰ 1980-1 C.B. 181.

³¹ *Penn*, 115 F.2d at 175 ("A cardinal principle of federal income taxation requires annual returns and accounting.").

³² *Id.* The sanctity of the annual accounting principle had been established in several Supreme Court cases. See, e.g., *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932); *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931).

Buyer was unable to have the property rezoned within a specified time; *Buyer* was unable to obtain rezoning and reconveyed the property pursuant to the contract, receiving his money back. In *Situation 1*, the time frame for obtaining rezoning was nine months, and the reconveyance occurred in October 1978. In *Situation 2*, the time frame for rezoning was one year, and the reconveyance occurred in February 1979. The ruling specified that in both situations, as a result of the reconveyance, *Buyer* and *Seller* were returned to the status quo ante and that the reconveyance operated as a rescission under state law. The IRS relied on *Penn* in concluding that unwind treatment applied only to the transactions in *Situation 1*. In *Situation 2*, *Seller* was required to report gain on the original sale and to treat the rescission as a separate purchase because the tax year for the original transaction had closed at the time of the rescission.³³

The main teaching of *Penn* and Revenue Ruling 80-58 is that unwinding treatment for sales rescissions is available as long as the rescission occurs in the same taxable year as the original transaction.³⁴ For this purpose, a transaction operates as a rescission only if it effects a complete cancellation of the underlying transaction, extinguishing all rights and obligations between the parties and restoring them to the relative positions they held before the first transaction.³⁵ As Revenue Ruling 80-58 indicates, the rescission right may be built into the original agreement, though its exercise probably cannot lie within the sole discretion of the party that seeks unwinding treatment.³⁶ An unconditional right to rescind for the buyer is indistinguishable from a sale of the property plus a put option.

³³ See also I.R.S. Tech. Adv. Mem. 78-02-003 (Sept. 28, 1977) (applying *Penn v. Robertson* to conclude that the taxpayer's repurchase of property sold earlier in the same year, pursuant to the purchaser's option in the original sales contract to reconvey the property to the taxpayer, effected a rescission that unwound the sale).

³⁴ 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, & GIFTS* ¶ 4.4.8 (3d ed. 2003). In Rev. Rul. 80-58, the IRS also noted that the reconveyance operated as a rescission for state-law purposes, but it does not appear that state-law determinations operate as either necessary or sufficient conditions for unwinding treatment under the federal tax law. See Banoff, *Unwinding*, *supra* note 1, at 965-67 (discussing cases where valid rescissions under state law did not retroactively unwind transactions for federal taxation purposes).

³⁵ See Rev. Rul. 80-58, 1980 C.B. 181.

³⁶ The fact that the exercise of the rescission right was involuntary "weighs in favor of treating the whole transaction as a nullity." I.R.S. Tech. Adv. Mem. 78-02-003. The reasoning on this point is, however, somewhat murky. The right to rescind appears to have rested in the sole discretion of the purchaser, a term that was agreed to by the seller. These issues are explored in detail in Part II, below.

Where the reversal does not restore the parties to the prior status quo, the IRS and the courts generally view unwinding treatment as inappropriate. For example, in Revenue Ruling 78-119,³⁷ the IRS denied unwinding treatment to a transaction that reversed a corporate reorganization because the purchasers retained dividends that had been distributed while they held the acquired stock. In *Dunlap v. Commissioner*,³⁸ the Tax Court denied unwind treatment to a contract cancellation where the overall effect of the parties' dealings was not a return to the status quo ante but the execution of a new sales contract with different terms. Similarly, the failure to satisfy the same-year requirement is generally fatal to the effort to obtain unwind treatment.³⁹

There are some instances in which courts have permitted (or the IRS has asserted) unwinding treatment where the requirements of Revenue Ruling 80-58 have not been met. For example, in one case the reconveyance occurred in the same tax year of just one of the parties. The IRS sought to deny unwind treatment because doing so would violate the annual accounting principle for the other party, but the Tax Court treated the reconveyance as an unwind for both.⁴⁰ In another situation, the IRS permitted tacking of holding periods on property reconveyed in a later taxable year.⁴¹ These cases, however, are infrequent and generally have proceeded on the theory that a refusal to accord unwind treatment to the transactions would permit taxpayer abuse.

³⁷ 1978-1 C.B. 277.

³⁸ 74 T.C. 1377 (1980), *rev'd on other grounds*, 670 F.2d 785 (8th Cir. 1982). The parties had agreed to sell bank stock once they received approval for the sale from the Federal Reserve Board. *Id.* at 1381. Two years later, when approval was not granted, the contract was cancelled and the parties executed a new sales contract providing slightly different terms from the original. *Id.* at 1384-85. The Tax Court treated the putative rescission and the new sales contract as a single transaction modifying the original agreement. *Id.* at 1419-20. It should be noted that the reversal also failed to satisfy the same-tax-year requirement, though the court did not focus on this problem. *See id.* at 1384-85.

³⁹ *See Banoff, Rescission*, *supra* note 17, at 7.

⁴⁰ *Fender Sales, Inc. v. C.I.R.*, 22 T.C. Memo 1963-119, *rev'd in part on other grounds*, 338 F.2d 924 (9th Cir. 1964).

⁴¹ I.R.S. Priv. Ltr. Rul. 80-20-140 (Feb. 26, 1980) (holding that a voidable sale by a trust of its property to the trustee, challenged by the trust beneficiaries and voided in a subsequent year, did not terminate the trust's holding period of the property for purposes of determining the character of gain on the subsequent sale to a third party by the trust).

In a pre-*Penn* case, *Ripley Realty Co. v. Commissioner*, 23 B.T.A. 1247, 1249 (1931), *aff'd*, 61 F.2d 1038 (2d Cir. 1932) (*per curiam*), the Board of Tax Appeals suggested in dicta that an effort to unwind undertaken after the close of the tax year might be effective. The Tax Court quoted this language favorably in its own dicta in a 1971 case, after the issue seemingly had been put to rest by *Penn*. *See Hope v. Comm'r*, 55 T.C. 1020, 1031 (1971), *aff'd*, 471 F.2d 738 (3d Cir. 1973).

One such case is *Guffey v. United States*.⁴² The taxpayers initially sold their residence at a \$700 loss to the buyers in 1951. In 1952, the buyers sued to rescind the transaction, and the property was ultimately returned to the sellers in 1954; they promptly sold it to a third party at an overall loss of approximately \$6000. The sellers deducted the latter loss under alternative theories of a bad debt deduction (with respect to the initial buyers' failure to pay the full purchase price under the installment note) and that the second, non-rescinded sale was entered into for the purpose of realizing income. The IRS sought unwind treatment of the rescission. The Ninth Circuit held that the three transactions were essentially one, a sale of the residence to the ultimate purchasers, the initial sale and rescission being treated as nullities. No deduction was allowed.⁴³

In the same vein, what counts as a complete rescission is not always clear, and the IRS sometimes has departed from the strict interpretation set out in Revenue Ruling 80-58. In at least one case, the IRS granted unwind treatment despite an ongoing indemnity agreement that the buyer and seller entered into in connection with the return of property to the original seller.⁴⁴ The indemnity covered the period during which the buyer held the property. Although such an arrangement clearly falls within the spirit of the status quo ante requirement, technically it represents a variation from the state of affairs prior to the original sale. Conversely, failure to create an indemnity obviously will not defeat unwinding treatment if the requirements are otherwise met.

The IRS has not stated an express rationale for the same-year rule, but one may assume it is that set forth in *Penn*: The same-year requirement reflects the perceived need to maintain orderly administration of the tax laws and could be considered to be mandated by early Supreme Court authority requiring annual accounting of gains and losses, absent an express Congressional override.⁴⁵

⁴² 339 F.2d 759 (9th Cir. 1964).

⁴³ See *id.* at 759. A possible basis for distinguishing *Guffey* from *Penn* and Revenue Ruling 80-58 is that the court in *Guffey* did not regard the initial sale as a completed transaction at the time of the reconveyance. *Id.* at 760-61. It is not clear what the court relied on as the basis for this claim, since the disposition of property pursuant to an installment obligation occurs on the date of sale. I.R.C. § 453(b)(1) (2006).

⁴⁴ See I.R.S. Priv. Ltr. Rul. 2005-33-002 (Apr. 28, 2005) (rescission of stock sale).

⁴⁵ *Penn*, 115 F.2d at 173, 175 (4th Cir. 1940) (noting that annual accounting is both a "practical necessity" and a "cardinal principle" of federal income taxation).

b. Retroactive Modifications

In a retroactive modification, the parties to the original agreement do not cancel it entirely, but instead cancel a portion of it retroactive to the date of the original transaction. In many cases, new terms may be substituted for the cancelled terms.⁴⁶ Such a modification is to be distinguished from a subsequent clarification of the meaning of the original agreement, though whether in any particular case the contractual change counts as such a clarification or as a retroactive modification may be hotly contested.⁴⁷ As an example, the parties to a long-term contract may specify in an amendment to the original agreement that work to be performed on a certain schedule will instead be performed on a different schedule. If the amendment explicates what the parties intended all along, it is not a modification; if it alters rights and obligations originally set out in the agreement, it is.⁴⁸

As contrasted with the rule for rescissions, the IRS generally takes the position that contractual modifications granted retroactive effect between the parties will not be given retroactive effect for tax purposes, absent an express statutory provision to the contrary.⁴⁹ The rationale offered, wholly apart from the need to respect the annual accounting principle, is that the government does

⁴⁶ See Banoff, *Unwinding*, *supra* note 1, at 973 (discussing modification of terms).

⁴⁷ See, e.g., *Estate of Holland v. Comm'r*, T.C.M. 1997-302 (finding that a scrivener's error failed to reflect actual transfer). Internal Revenue Code section 108(e)(5) represents a Congressional override of factual disagreements on precisely this type of question. See I.R.C. § 108(e)(5) (2006). The provision requires a *per se* characterization of a reduction of purchase-money debt of a solvent debtor as a price adjustment if the reduction otherwise would qualify as income from cancellation of debt. *Id.* The Senate Finance Committee describes the provision as "intended to eliminate disagreements between the Internal Revenue Service and the debtor as to whether . . . the debt reduction should be treated as discharge income [i.e., akin to a reversal] or a true price adjustment [i.e., akin to a clarification]." S. Rep. No. 96-1035, at 16 (1980), *reprinted in* 1980 U.S.C.A.N. 7017, 7031. The term "modification" as used in this subsection also does not embrace a court-ordered change to contractual or other terms, which falls under the reformation heading, discussed *infra* Part I.B.2.

⁴⁸ See *Estate of Ballantyne v. Comm'r*, 341 F.3d 802, 807 (8th Cir. 2003) (denying retroactive effect to 1998 settlement of dispute between partners pursuant to which all of the partnership's 1994 sale proceeds were allocated to one partner). See *generally* *Mikel v. Gourley*, 951 F.2d 166, 169 (8th Cir. 1991) (distinguishing clarification from modification because the former "does not change the parties' original relationship, but merely restates that relationship in new terms") (citation omitted); *McKay Nissan, Ltd. v. Nissan Motor Corp. U.S.A.*, 764 F. Supp. 1318, 1319 (N.D. Ill. 1991) ("[T]he modifications must effect a material alteration of the parties' rights and obligations before it can be said that the parties intended a new contract or agreement.") (citations omitted).

⁴⁹ Banoff, *Unwinding*, *supra* note 1, at 974; accord I.R.S. Field Serv. Adv. Mem. 2000-028-019 (Apr. 14, 2000), at 6 n.3.

not consider itself bound by agreements between the parties concerning the retroactive effects of the modification.⁵⁰

This rationale is, to say the least, puzzling in light of the rescission rule, since rescissions may be the result of the parties' mere agreement. As Banoff points out, the true reasons for the refusal to give retroactive effect to modifications likely relate more to the greater opportunity for collusive, tax-motivated arrangements between the parties than are available in the rescission context.⁵¹ Bearing in mind that the question is not whether to respect the modification transaction itself but whether to give it retroactive effect, it often will be much harder to have confidence that the modification is a reversal (together with, in some cases, the addition of new terms) than a simple change of course. In addition, the opportunity for tax avoidance is much greater, because a contractual modification is less likely, in itself, to reflect a desire to back out of the changed terms than simply to change them in light of changed circumstances or, perhaps, purely for tax reasons. In other words, rescissions are usually reversals and modifications often are not, even with respect to the portion of the first transaction that is cancelled.

2. *Reformations*

In a reformation, the reversal happens pursuant to a court order that purports to "re-form" part or all of the first transaction retroactive to the date on which the parties entered into that transaction, in order to give effect to the parties' intentions.⁵² In contrast to the rescission and modification cases, the tax reformation authorities much more commonly involve donative transfers or arrangements than exchanges of value for value. Both the courts and the IRS have generally ruled that purportedly retroactive reformations will not be given retroactive effect for federal income tax purposes.⁵³

⁵⁰ See *Van Den Wymelenberg v. United States*, 397 F.2d 443, 445 (7th Cir. 1968) (stating that reformation does not affect rights acquired by non-parties, such as the government, from original agreements).

⁵¹ See Banoff, *Unwinding*, *supra* note 1, at 974.

⁵² See *id.* at 975.

⁵³ See Rev. Rul. 93-79, 1993-2 C.B. 270. A separate line of cases accords quasi-retroactive treatment to judicial constructions of trusts and other instruments that affect previously adjudicated tax liability. See, e.g., *Blair v. Comm'r*, 300 U.S. 5 (1937) (holding that a state court construction of trust instrument made after tax liability for relevant period was determined did not preclude that construction from applying to and re-determining taxpayer's tax liability for that period); *Kelly's Trust v. Comm'r*, 168 F.2d 198 (2d Cir. 1948) (same). The treatment is aptly termed quasi-retroactive because the interpretation purports to state what the relevant agreement or arrangement always was, not to change it to reflect what the parties intended but failed to do.

Two common reformation settings are trust arrangements and divorce decrees. *Sinopoulo v. Jones*⁵⁴ is a typical trust case. The settlor-trustee formed two trusts in 1930 and transferred stock to them at that time and at various points thereafter.⁵⁵ No formal declarations of trust were made until December 14, 1939.⁵⁶ The trusts were intended to be irrevocable but contained no language to that effect.⁵⁷ After the settlor made the formal declarations of trust, Oklahoma passed a statute, effective August 21, 1941, providing that a trust would not be treated as irrevocable unless the trust instrument specifically stated as much.⁵⁸ Concerned that the statute would be applied to the trusts to treat them as revocable, one of the beneficiaries instituted an adversary proceeding in state court against the settlor seeking a construction of the trust instruments and reformation of them, retroactive to 1939, to provide that they were irrevocable.⁵⁹ The state court found that the trusts had been intended to be irrevocable from their formation, in 1930, and reformed them, retroactive to the date of declaration of the trusts, to conform to the requirements of Oklahoma law.⁶⁰

The settlor then brought a suit in the Oklahoma federal district court seeking a refund of taxes paid on trust income for the years 1939, 1940, and 1941.⁶¹ The district court held, however, that the reformations, to the extent they purported to apply retroactively, were ineffective with respect to the federal tax authorities, and the Tenth Circuit, relying in part on the common law of reformations, agreed:

The liability of appellant for the income tax chargeable to the income of the trusts for the years in question must be determined from the provisions of the trusts prior to their reformation by the state court. While the judgment of the state court made the reformation of the trusts retroactive and effective as of the date of the execution, this

⁵⁴ 154 F.2d 648 (10th Cir. 1946); see also *M.T. Straight's Trust v. Comm'r*, 245 F.2d 327 (8th Cir. 1957) (holding a state-court reformation decree not effective for federal income tax purposes); *Van Den Wymelenberg*, 397 F.2d at 443 (amended trust agreement executed in 1963 did not retroactively affect the federal gift tax consequences of 1961 gift in trust). But see *Flitcroft v. Comm'r*, 328 F.2d 449 (9th Cir. 1964) (permitting the retroactive reformation of a trust). The IRS expressly declined to follow *Flitcroft* in Revenue Ruling 93-79. See 1993-2 C.B. 269, 270.

⁵⁵ See *Sinopoulo*, 154 F.2d at 649.

⁵⁶ *Id.*

⁵⁷ See *id.* at 650.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Sinopoulo*, 154 F.2d at 648.

could not affect the rights of the government under its tax laws. It is a general rule that as between parties to an instrument a reformation relates back to the date of the instrument, but that as to third parties who have acquired rights under the instrument, the reformation is effective only from the date thereof.⁶²

The IRS's position on reformations, set forth in Revenue Ruling 93-79, rests on the same rationale.⁶³ Revenue Ruling 93-79 involved reformation of a trust that was a shareholder in a corporation purporting to qualify as an S corporation.⁶⁴ The trust failed to satisfy the definition of a "qualified subchapter S trust" because its terms did not require that any corpus of the trust distributed be distributed to the current income beneficiary.⁶⁵ As a result, the trust was a prohibited shareholder, and the corporation failed to qualify as an S corporation.⁶⁶ In order to rectify the problem, the trust beneficiaries executed an agreement, ratified by a state court, that retroactively reformed the trust to the date of its creation.⁶⁷ The IRS held that the reformation lacked retroactive effect with respect to the government.⁶⁸ Therefore, the trust was not a qualified Subchapter S trust from the date of its formation, but only from the date of amendment of the trust's terms.⁶⁹

A similar rule applies in the typically adversarial setting of divorce-decree reformations.⁷⁰ The reformation will not be accorded retroactive income tax effect unless the modification either purports to correct a failure of the original decree to reflect the intention of the court or was not legally valid at the time it

⁶² *Id.* at 650 (footnote omitted).

⁶³ See 1993-2 C.B. 269; see also I.R.S. Tech. Adv. Mem. 93-47-003 (Aug. 5, 1993) (explaining that state court reformations lack power to make gifts, initially revocable under state law, irrevocable on retroactive basis for purposes of federal gift and estate tax liability); I.R.S. Tech. Adv. Mem. 92-31-003 (Apr. 9, 1992) (same).

⁶⁴ See 1993-2 C.B. 269; I.R.C. § 1361(a)(1) (2006) (defining "S corporation" as a "small business corporation" for which an election has been made under I.R.C. § 1362(a)), 1361(b) (defining "small business corporation").

⁶⁵ See 1993-2 C.B. 269. Specifically, the provisions of the trust violated the corpus distribution limitation. I.R.C. § 1361(d)(3)(A)(ii).

⁶⁶ 1993-2 C.B. 269; see also I.R.C. § 1361(b)(1)(B) (providing that a corporation will not qualify as a "small business corporation" eligible to elect S corporation status unless, among other things, its shareholders do not include trusts other than certain qualified trusts).

⁶⁷ Rev. Rul. 93-79, 1993-2 C.B. 269.

⁶⁸ *Id.* at 270.

⁶⁹ *Id.*

⁷⁰ See BITTKER & LOKKEN, *supra* note 34, ¶ 77.1 Divorce-decree reformations may be non-adversarial where the purpose of the reformation is to increase the after-tax size of the parties' combined pie rather than to secure a greater allocation of income or property to one party at the expense of the other.

was entered.⁷¹ Among the rationales offered are the necessity of annual computations of income⁷² and the concern that the government will be deprived of its rights if it is not a party to the underlying state action.⁷³ For example, in *Gordon v. Commissioner*, the divorced spouses procured a state-court consent decree invalidating in part their earlier divorce settlement and re-characterizing a portion of the ex-husband's previously paid child support as alimony.⁷⁴ The Tax Court refused to give the consent decree retroactive effect for federal tax purposes.⁷⁵

The rationales for the reformation rule are hard to make out, both on their own terms and in light of the rescission rule. The IRS argues, and the courts have generally agreed, that the federal government is not bound by a state-court reformation to which it is not a party.⁷⁶ The IRS has then refused to give retroactive effect to reformations on the ground that the possibility of collusive action by the parties permits two bites at the tax apple.⁷⁷ Presumably the most common abuse the government has in mind is taxpayers' use of information that can only become available after they have entered into their transaction to

⁷¹ See, e.g., *Gordon v. Comm'r*, 70 T.C. 525 530-31 (1978) (stating the general rule and the exception for an unlawful initial decree but declining to find the decree unlawful in the instant case); cf. *Muss v. Comm'r*, T.C.M. 1970-171 (holding that subsequent state-court specification of breakdown of payments to ex-spouse clarified original decree and granting retroactive effect).

⁷² See *Van Vlaanderen v. Comm'r*, 10 T.C. 706, 708 (1948).

⁷³ See *Guthrie v. United States*, 264 F. Supp. 840, 844 (W.D. Ark. 1967).

⁷⁴ *Gordon*, 70 T.C. at 527-28.

⁷⁵ *Id.* at 530.

⁷⁶ See *Sinopoulo v. Jones*, 154 F.2d 648, 651 (10th Cir. 1946) (holding that a subsequent state-court reformation does not affect the rights of the federal government under federal tax laws); *M.T. Straight's Trust v. Comm'r*, 245 F.2d 327 (8th Cir. 1957) (holding a state-court reformation decree ineffective for federal income tax purposes).

The leading case on the related issue of the deference owed to state court adjudications for federal tax purposes is *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), in which the Supreme Court held that federal tax authorities are not bound by state trial court adjudications of state substantive rights for purposes of determining federal estate tax liability. *Id.* at 457. The rationale, however, is not that federal authorities are entitled to disregard state law, but that only decisions of the highest state court provide authoritative determinations of state law; "proper regard" is to be accorded the decisions of lower state courts. *Id.* at 456. When no decision of the highest state court is available, federal authorities are to "sit[] as a state court," in order to arrive at their determination of how the state's highest court would rule on the question. *Id.* *Bosch* has been roundly and persuasively criticized as both overly deferential to potentially collusive state court judgments and insufficiently deferential to genuinely adversarial state court proceedings. See, e.g., Bernard Wolfman, *Bosch, Its Implications and Aftermath: The Effect of State Court Adjudications on Federal Tax Litigation*, 3 U. MIAMI INST. ON EST. PLAN. 2-1 (1969).

⁷⁷ See, e.g., *Estate of La Meres v. Comm'r*, 98 T.C. 294, 311-12 (1992) ("[W]ere the law otherwise there would exist considerable opportunity for 'collusive' state court actions having the sole purpose of reducing federal tax liabilities."); *Flitcroft v. Comm'r*, 328 F.2d 449 (9th Cir. 1964) ("[W]here the state court judgment is obtained through 'collusion' for the purpose of avoiding tax liability, it has no binding effect.").

determine the tax consequences of their actions. A typical situation would be one in which the first transaction yielded uncertain consequences that would be resolved only subsequently, such as an installment sale for contingent consideration.⁷⁸ If the parties to the sale initially contemplated that most gain would be recognized in later years, but the gain turned out to be recognized earlier, they might seek reformation in order to account for the gain differently, such as by treating the transaction as the formation of a partnership or as some other arrangement.⁷⁹ Finally, both the IRS and the courts have stated that a retroactivity rule for reformations would undermine the value of finality, leaving tax liabilities unsettled far into the future.⁸⁰

Each of these rationales for denying unwind treatment to reformations is open to question. Consider first the idea that the government is not bound by the reformation because it is not a party to it. The argument generally offered in support of the rule is that it is inequitable, and indeed “beyond the power of a [s]tate [c]ourt,” to deprive the government of rights it has acquired under the original agreement.⁸¹ This argument, however, presupposes that the question of what the government’s rights are has been settled. Indeed, the proposition is in tension with the normal operation of the tax law, which generally treats underlying entitlements and obligations established by state (or other) substantive law as determinative of the federal tax consequences of transactions.⁸² Tax treatment does not hinge on whether the government is a party, in one way or another, to a transaction, but on the transaction’s economic (and to some extent legal) effects. For example, the parties may have believed that the execution of a trust agreement provided each with certain rights and obligations under state law. If it later turns out that the parties were mistaken, as a matter of law, about the legal effect of the trust document, it is not clear why a reformation of the instrument to provide those

⁷⁸ See I.R.C. § 453 (2006) (providing for installment sale treatment of certain installment purchases); Temp. Treas. Reg. § 15A.453-1(c) (1981) (providing for treatment of contingent payment installment notes).

⁷⁹ See generally Temp. Treas. Reg. § 15A.453-1(c)(1) (1981).

⁸⁰ See, e.g., *Van Den Wymelenberg v. United States*, 397 F.2d 443, 445 (7th Cir. 1968) (“[F]ederal tax liabilities would remain unsettled for years after their assessment if state courts and private persons were empowered to retroactively affect the tax consequences of completed transactions and completed tax years.”); see also I.R.S. Tech. Adv. Mem. 93-47-003 (Aug. 5, 1993) (citing *Van Den Wymelenberg* for this proposition); I.R.S. Tech. Adv. Mem. 92-31-003 (Apr. 9, 1992) (same).

⁸¹ *M.T. Straight’s Trust v. Comm’r*, 245 F.2d 327, 329 (8th Cir. 1957).

⁸² See *United States v. Irvine*, 511 U.S. 224, 239 (1994) (explaining that federal tax “provisions are not to be taken as subject to state control or limitation”); *Helvering v. Stuart*, 317 U.S. 154, 162 (1942) (“Once rights are obtained by local law, whatever they may be called, these rights are subject to the federal definition of taxability.”); see generally BITTKER & LOKKEN, *supra* note 34, ¶ 4.1.

rights deprives the government of its rights. To say that the government is deprived of rights that have accrued under the original instrument is to assume what is to be established, which is that the original agreement deserves to be respected as having established the parties' rights and obligations for tax purposes.⁸³ While that may be the case, no argument for it is presented in stating that reformations inequitably deprive the government of rights vested under prior agreements.

One might cast the "not a party to the action" argument slightly differently, as merely stating the point that the absence of court jurisdiction over the federal taxing authority means that ordinary substance-over-form principles, rather than a binding judgment of the court, govern the tax treatment of the reformation. On this interpretation, reformations are not retroactively binding because they are not, in substance, retroactive: The substance of a reformation is not a change to what happened in the past, which, technically, is not possible, but a prospective change designed to make the totality of what happens pursuant to the parties' arrangement reflect what they intended, in hindsight, to have happen. Therefore, it can be accorded retroactive effect only if everyone affected agrees. So viewed, the retroactive aspect of the reformation is purely fictional, and the IRS will not respect it as long as it is not compelled to by virtue of having been a party subject to the state court's jurisdiction. This argument, however, is similarly question-begging if it is meant to defend any rule other than a general policy of no unwinding treatment at all. The same objection could be raised, after all, to a contractual rescission: It does not change what happened in the past. If a distinction on this point is thought to survive between rescissions and reformations, then one needs to know why some purportedly retroactive actions have substance and others do not. Further, the notion that respecting the retroactive nature of the state court's determination differs categorically from according respect to state law in effect at the time of the first transaction is unsupported. At bottom, respect for either is conventional; it rests on policy considerations. Therefore, no justification for refusing to respect the binding character of retroactive adjudications is articulated merely by noting that the adjudication is retroactive rather than prospective in character or by asserting that the retroactive adjudication is formal rather than substantive. Whether it is "formal" or

⁸³ The IRS has accepted this principle in the limited context of *nunc pro tunc* orders modifying divorce decrees. See, e.g., Rev. Rul. 71-416, 1971-2 C.B. 83. The IRS position, however, seems to be confined to computational and clerical errors. See *id.*; see also discussion *infra* Part I.B.3.

“substantive” depends on whether it is a good idea to respect retroactive adjudications of legal rights and obligations in the first place.

Difficulties also afflict the notion that the possibility of collusion between the parties requires a general rule of no unwinding for reformations. As an initial matter, the objection seems to rest on evidentiary grounds, not substantive ones.⁸⁴ Some, perhaps many, reformations will result from collusive arrangements, but surely many will not; moreover, federal authorities—be they courts or the IRS—may independently determine what they believe should be the proper result under the substantive law, thereby ameliorating worries about the potentially binding effects of state determinations.⁸⁵ Therefore, one would expect a more flexible rule on reformations, rather than a policy of disregarding them except in narrowly circumscribed cases. Secondly, where the circumstances that might suggest tax collusion also would raise a concern for purposes of underlying substantive law, reformation ought to count as evidence for the opposite inference that the parties were not acting collusively. Thus, in some instances reformation should provide assurance rather than cause for concern.⁸⁶ Finally, and most importantly, the collusion rationale is also basically inconsistent with the rescission rule. In both cases, the effort to alter the nature of the transaction may be tax-motivated.

This last point can readily be seen from the IRS’s own stated ruling position on rescissions in Revenue Ruling 80-58, which, as noted, creates ample opportunity for tax planning.⁸⁷ If the IRS is going to sign off on unwinding treatment for a rescission of that variety, it is unclear why the rule

⁸⁴ In particular, see the discussion in *Flitcroft v. Commissioner*, 328 F.2d 449 (9th Cir. 1964), of collusion as an evidentiary problem to be addressed on a case-by-case basis. *Id.* at 453 nn. 9–10. Another case, *Gallagher v. Smith*, stated the point as follows: “[W]e think that the fact that the parties all favored the same result in the state court is relevant only so far as it is evidence of collusion” 223 F.2d 218, 225 (3d Cir. 1955). Although *Gallagher*’s statement of the collusion point appears to reflect at least one strand (and, as argued below, the better strand) of current doctrine on the federal effect of state-court adjudications, the court further stated that even an erroneous state court adjudication of property rights required a federal court’s “full faith and credit” as long as the decision was not collusive. *Id.* at 226. This position is contrary to the Supreme Court’s subsequent holding in *Commissioner v. Bosch’s Estate*, 387 U.S. 456 (1967), discussed *infra* notes 85–86 and accompanying text.

⁸⁵ *Bosch*, 387 U.S. at 457 (holding that federal authorities are not bound by the state court determination where the federal estate tax liability depends upon the character of a property interest held and transferred by a decedent under state law).

⁸⁶ See *id.* at 481 (Harlan, J., dissenting) (arguing that the standard for whether state trial court judgments have binding effect on federal authorities should be whether the proceedings are adversarial in nature and provide a full opportunity to air the issues).

⁸⁷ See 1980-1 C.B. 181.

for reformations should be different; conversely, if there is to be a blanket rule against unwinding a reformation on the ground that parties can choose their tax results, it ought to apply to rescissions as well.

Finally, the worry that according retroactive effect to modifications will undermine the policy of finality for determination of federal tax liability seems overstated. A more permissive retroactivity rule need not extend the retroactivity of reformations to closed tax years, which are generally those more than three years prior to the current year.⁸⁸ Nor would such a rule require disregard of other relevant factors, such as collusion or tax motivation, or open the door to routine reformations. Most importantly, it would not prevent the IRS from looking to other factors that ought to guide the analysis of whether a reformation should be accorded retroactive effect.

3. *Cancellation of a Gift*

The last common unwind I examine is the cancellation of a gift.⁸⁹ The majority of cases deal with the gift tax consequences of such cancellations, though a few have arisen under the income tax in connection with charitable contribution property.⁹⁰ In the income tax context, courts will give retroactive effect to documents purporting to change the terms of an earlier gift only where it is possible to show that the transaction as consummated did not represent a completed gift at the time it took place. If, instead, subsequent considerations motivate the reversal or cancellation, unwinding treatment generally will not apply, even if the later considerations relate to the state of affairs at or prior to the time of the original gift.

One line of cases exemplifying this approach addresses putative gifts larger than or different from what the donor intended. In *Dodge v. Commissioner*,⁹¹ a case involving an income tax deduction for a charitable contribution, the Tax Court treated as void *ab initio* four-fifths of a charitable contribution made in 1960, where the donation of that portion of the amount originally contributed was the result of a scrivener's error.⁹² The Tax Court's decision rested on the conclusions that donative intent was lacking with respect to the excess portion of the property originally transferred and that, under relevant common law

⁸⁸ I.R.C. § 6511(a) (2006).

⁸⁹ See Banoff, *Unwinding*, *supra* note 1, at 982–83, for a discussion of these cases.

⁹⁰ See, e.g., *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Cl. Ct. 1967).

⁹¹ T.C.M. 1968-238.

⁹² See *id.*

principles as they would be interpreted by the state court where the property was situated, no transfer of the excess took place because of the absence of intent.⁹³ The gift was therefore incomplete at the time it purportedly was made.⁹⁴

A separate line of cases applies specifically to the federal gift tax consequences of cancellations of apparently completed gifts.⁹⁵ Here, the rules are somewhat more liberal. State-court sanctioned reformations of donative instruments originally intended to be irrevocable generally will be given retroactive gift tax effect if, under state law, a unilateral mistake was the basis for making the gift—typically a gift in trust—irrevocable.⁹⁶ For example, in *Berger v. United States*, the taxpayer transferred property into a trust based on the mistaken belief that conflict-of-interest rules required his doing so as a condition of employment with the Nixon Administration.⁹⁷ When it became apparent that the rules did not require the transfer, he obtained a state court judgment retroactively rescinding it pursuant to state law, which provided that a gift based on a unilateral mistake is revocable at the instance of the donor. In a separate suit for refund of the gift tax paid on the rescinded gift, the district court gave retroactive effect to the state court judgment.

The rationale for this rule is that there can be no gift tax because the tax, as a transfer tax, cannot apply where there has been no completed transfer.⁹⁸ The difference between this case and the *Dodge*-type case is that unwinding will apply even if the mistake concerns the consequences of the gift, as long as state

⁹³ *Id.* Note that the rule generally does not apply where the mistake concerns the federal tax consequences of the gift. See, e.g., *Board v. Comm'r*, 14 T.C. 322 (1950) (refusing to treat as void *ab initio* gifts that were subsequently returned in order to minimize the future estate tax liability of the donor); I.R.S. Priv. Ltr. Rul. 91-27-008 (no date available) (denying retroactive effect to postponement of trust termination until after death of trust settlor).

⁹⁴ *Id.* To the same effect is *Touche v. Commissioner*, 58 T.C. 565 (1972); *acq.*, 1977-2 C.B. 3.

⁹⁵ See *Berger v. United States*, 487 F. Supp. 49, 51-52 (W.D. Pa. 1980) (discussing authorities).

⁹⁶ See *id.*

⁹⁷ *Id.* Note that the IRS seems somewhat less receptive to this rule. In Private Letter Ruling 84-33-024 (May 10, 1984), the IRS denied retroactive effect, for gift tax purposes, to a state-court reformation of a gift in trust to make the transfer a gift of a present interest rather than of a future interest. The ruling may have been based on the fact that the reformation was tax-motivated, though the ruling does not identify tax motivation as a reason for denying unwind treatment. And in Private Letter Ruling 94-08-005 (Nov. 15, 1993), the IRS described *Berger* as applying in “some very limited situations.”

On the other hand, in *Neal v. United States*, 83 A.F.T.R. 2d 99-2325 (3d Cir. Apr. 12, 1999) (memorandum opinion), the court gave retroactive effect to a trust reformation based on a mistake of federal tax law that arose because Congress changed the law and deemed it to apply retroactively. The court cited *Berger* favorably. *Id.* at 99-2327

⁹⁸ *Berger*, 487 F. Supp. at 51-52; see also *Neal*, 83 A.F.T.R. 2d 99-2325.

law provides that such a mistake renders the gift incomplete. As evidenced by the *Berger* case, the rule applies even where the mistake is one of local law, assuming that the state law on revocations permits revocation in such a case.⁹⁹ By contrast, the more limited rule under the income tax applies only when there is a factual error that goes to the nature of the transaction itself.¹⁰⁰

C. Summary

The following lessons may be drawn from the preceding discussion.

- As a general matter, courts and the IRS are more apt to grant unwind treatment to reversals where the original transaction triggers an excise or other transactional tax than where it triggers an income tax.
- For the set of cases dealing with reversals under the income tax, a current-year reversal is apt to receive unwind treatment only if the reversal is complete (e.g., a rescission) and the transaction is at arm's length. Where the transaction involves a donative transfer or combines a reversal with new contractual terms, unwind treatment is unlikely to be available.
- Where the reversal occurs in a later tax year, unwind treatment is unavailable under the income tax.

For the reasons alluded to earlier, it is hard to make sense of these rules. First, it is not immediately clear why a more lenient approach to unwinding applies in the transactional tax setting than in the income tax setting. The kinds of events that give rise to the reversal would seem to be the same in both cases. Second, if the IRS is willing to accord unwind treatment to a complete rescission, it is not obvious why a blanket rule against unwinding in either the contractual modification or the reformation case is necessary. If the concerns

⁹⁹ *Berger*, 487 F. Supp. at 51–52. The rule does not extend to mistakes of federal tax law. *Board v. Comm'r*, 14 T.C. 322, 325 (1950); see also I.R.S. Priv. Ltr. Rul. 82-05-019 (Nov. 3, 1981) (stating that when the mistake is of federal tax law, “a state court proceeding has no effect on federal tax liability and the gift is considered complete”). But see *Neal*, 83 A.F.T.R. 2d 99-2325 (unwinding a gift tax where the “mistake” of federal tax law resulted from Congress’s retroactively effective change to it).

¹⁰⁰ The same distinction operates in the § 83 context, discussed below. A service provider may revoke an election made under § 83(b) after the deadline for making the initial election only where a mistake as to the nature of the property transferred formed the basis for the election. A mistake concerning the circumstances of the property transfer is not a valid basis for revocation. See Reg. § 1.83-2(f) (2007); Rev. Proc. 2006-31, 2006-27 I.R.B. 13.

that lead to such a blanket rule in the modification and reformation contexts are valid, it is unclear why some of the same concerns do not apply in the rescission case as well. Finally, as explained in Part II, the centrality of the annual accounting principle to the availability of unwind treatment is somewhat mysterious given the similarity between unwinding and other types of errors for which later-year relief is available. The next Part addresses these issues and offers a more consistent theory of unwinding.

II. UNWINDING AND ERRORS IN GENERAL

This Part analyzes the concept of unwinding more systematically than the authorities and commentaries have done, setting aside, however, the issues of tax motivation and administrability.¹⁰¹ Part II.A expands on the preliminary definition of unwinding developed in Part I.A, Part II.B analyzes unwinding as a type of error analogous to other kinds of taxpayer error for which more comprehensive and expansive doctrines already exist, and Part II.C draws conclusions for the proper direction of unwinding doctrine under the income tax.

A. Conceptual Underpinnings of Unwinding

1. Transactional Versus Income Taxes

As suggested in the Introduction, and as borne out by the authorities examined in Part I, the unwind analysis depends in part on the type of tax involved. Where the event “itself” in the first transaction is what is taxed and the reversal cancels the event, unwinding treatment is more likely to result, regardless of whether the possibility of a reversal was contemplated at the time of the first transaction, as long as the reversal is not tax-motivated. For example, A may purchase an item subject to retail sales tax, aware that the item may turn out to be of no use to her. If she returns the item unused, the return operates as a reversal and the sales tax ordinarily is unwound despite the fact that the return was anticipated.¹⁰² Similarly, a tax levied on a gift should be unwound if the donee returns the gift in a genuine reversal.¹⁰³

¹⁰¹ These issues are taken up *infra*, Part III.

¹⁰² See, e.g., CAL. REV. & TAX CODE § 6012(c)(2) (West 2003).

¹⁰³ As a general matter, gifts that are “incomplete” are not taxable gifts, and gifts rescinded because made under a unilateral mistake of law or fact are treated as incomplete for gift tax purposes. *Berger v. United States*, 487 F. Supp. 49, 51–52 (W.D. Pa. 1980). An exception provides that where the mistake is one of

It is possible to offer a reasoned justification for this dichotomy. In the first place, consider that a transactional tax is best understood as applying solely to “successful” transactions.¹⁰⁴ That is, a contrary unwinding rule would be hard to justify, given that the reversal means the parties view the initial transaction as a mistake and the second as nullifying it. If tax applies nonetheless, then the tax becomes a simple transfer tax that is punitive in the case where the transaction fails. A retail sales tax would instead become a tax on transfers made between persons in the business of selling and persons who are potential customers; this is similar to cases in which a gift tax applied even when the gift was returned. In a sense, the tax itself becomes arbitrary to the extent it purports to be associated with the particular kind of transaction if the tax continues to apply after the parties have canceled the transaction as between themselves.

Secondly, such a rule likely would create deadweight loss without any meaningful tax benefit.¹⁰⁵ Consider the basic case of a retail sales tax. Assume the return was considered distinct from the original sale but not itself taxable, so that on return, the original tax would remain but no additional tax was due. (If both transactions are taxable then the effects are exacerbated.) In that case, a return would cause the purchaser to bear the liability for the tax without having purchased anything. On one hand, such a rule might raise more tax and, to the extent it did not, would discourage ill-considered purchases; but on the other, it would make purchasers decide whether to purchase property based on less information than they currently have if they want to avoid the additional tax. The situation would be worse in the case of items purchased as gifts, where the purchaser is less likely to know whether the purchase will be successful. It might be that the rule would permit the tax rate to be lower, but at a likely cost of some combination of inefficiently fewer initial purchases and inefficiently fewer later returns. These results follow because a rule that encourages final decisions under less information will always be less efficient

federal tax law, the gift will not be treated as incomplete and the rescission counts as a separate gift. *See Board v. Comm’r*, 14 T.C. 322 (1950); *see also* I.R.S. Priv. Ltr. Rul. 82-05-019 (Nov. 3, 1981) (reviewing authorities).

¹⁰⁴ One must be careful to distinguish the nature of the tax as transactional from the separate question of the purpose of the tax. Both a transactional tax and a non-transactional tax, like an income or a property tax, can be designed with the same purposes in mind. An income tax may be enacted for the purpose of paying for services that are roughly correlated with income, while a sales tax may be designed to raise revenue for purposes of redistribution. The issue under discussion is which unwind rule should apply to reversals under a particular kind of tax, and the claim is that the rule does not depend on the purpose of the tax but on its nature.

¹⁰⁵ Deadweight loss (or “excess burden”) is the efficiency loss associated with the imposition of the tax. HARVEY S. ROSEN, *PUBLIC FINANCE* 304 (7th ed. 2005).

than one that does not, as long as strategic considerations are not in play. In the present circumstance, the rule would create an inefficient subsidy from those who return to those who do not.¹⁰⁶

2. *Why the Income Tax Is Not a Tax on Transactions*

Things are somewhat different in the case of the income tax. The argument that the reversal of a transaction subject to a transactional tax ordinarily merits unwind treatment rests on the notion that the reversal eliminates the very thing that is subject to tax—in the case of a sales tax, the sale; in the case of a gift tax, the gift. As argued below, the income tax is not so much a tax on transactions as it is a tax that is triggered by them. For this reason, the connection between the reversal and the unwind is more tenuous, resting on considerations external to the tax itself. The question of whether unwinding treatment should apply depends not on whether the taxpayer “has” the income or loss, but on whether the considerations that support levying tax at the time of disposition are overcome if the disposition is reversed. Likewise, the efficiency argument runs differently under the income tax, because the question is not whether a tax will be collected, but when it will be collected.

Two arguments support the claim that the income tax, at bottom, is not a tax on transactions. First, the income concept that is widely accepted as a normative baseline for the income tax, the so-called “Haig-Simons” concept, does not tie income to transactions. Secondly, even if the existence of a transaction is viewed as more closely determining the question of whether a taxpayer has income, the transaction functions as a timing device; it does not create the tax.

a. *Haig-Simons Income Concept*

The Haig-Simons conception of income, named after the two theorists who are credited with having articulated it, defines income as the net change in a taxpayer’s wealth (including wealth spent on consumption) during the tax period.¹⁰⁷ The occurrence or not of transactions is irrelevant to the amount of the taxpayer’s income or loss and, therefore, to the amount of income tax

¹⁰⁶ That is, the regime will create costs that cannot be effectively internalized.

¹⁰⁷ See HENRY C. SIMONS, PERSONAL INCOME TAXATION 206 (1938), for a discussion of the nature of an income tax as a tax on net changes in wealth. See also Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, Or Why the Accrual Method Should Be Eliminated*, 26 VA. TAX REV. 245, 248 (2007) (describing Simons’s concept of income as “the gold standard in academic circles”).

liability the taxpayer has during the tax period. Thus, the Haig-Simons definition takes into account the net appreciation and depreciation of assets held during the tax period, without regard to whether the assets are retained or sold. For example, whether or not *A* sells *Blackacre* on December 31, her tax liability for the year ending on that date is the same, because the increase or decline in value of *Blackacre* is definitive of whether she has taxable income or loss. From a Haig-Simons perspective, the non-taxation of accrued but unrealized gain or loss represents an accommodation of the income tax to other exigencies, principally the problems of valuation, liquidity, and political acceptability.¹⁰⁸ In other words, the transactional features of the income tax as administered have nothing to do with the true object of the tax. Yet, unwinding is transactional in its essence. It is an effort to nullify the tax consequences that result from transactions or arrangements previously entered into. Thus, if the income tax were a “pure” Haig-Simons tax, virtually nothing would hinge on a reversal. The tax results would be largely the same.

As an example, consider a standard unwind under a pure Haig-Simons income tax. Under such a tax, taxpayers would accrue income and loss during the tax period and pay tax on the net gains or losses at the end of the period, without regard to any disposition of items on which tax were imposed. Basis would be adjusted to fair market value at the end of each period to reflect the reckoning of income tax for that period. If *S* sold *Blackacre* to *B* sometime during the year and the transaction were reversed during the same year, then at the end of the year *S* would have exactly the same Haig-Simons income, regardless of whether the reversal constituted an unwind or a separate transaction. In either case, she would be taxed on the difference in value in *Blackacre* between the end of the current year and the end of the prior year.¹⁰⁹

If the transaction were reversed in a later year, variations in the total tax due could arise because unwind treatment would cause *S* to be taxed in the interim years on the value of *Blackacre*, rather than on any gains or losses resulting from the investment of the proceeds of its sale. These variations, however, would be unsystematic in direction (sometimes resulting in more tax for *S*, and sometimes less) and offset by equal and opposite variations to the counterparty, *B*. The only net difference, if any, in overall tax liability would

¹⁰⁸ See Dodge, *supra* note 107, at 256.

¹⁰⁹ This kind of mark-to-market accounting applies in certain narrow cases under the income tax. See, e.g., I.R.C. §§ 471 (inventory), 475 (dealers in securities), 1256 (certain forward, futures, and option contracts) (2006).

result from different marginal rates applicable to *S* and *B*. In short, unwinding under a Haig-Simons tax becomes essentially a non-issue.

b. "When" Versus "Whether"

One might accept the preceding characterization of the implications of a Haig-Simons tax for unwinding, but object to it as not relevant on the ground that the Haig-Simons concept does not, in fact, supply the normative definition of income under the actual income tax. For one thing, the actual tax has always incorporated a realization requirement for most forms of income, and likely always will.¹¹⁰ Moreover, the historical justification for the income tax has more to do with practical ability-to-pay concepts than with the ideal of taxing Haig-Simons income.¹¹¹ Actual ability to pay hinges in some measure on liquidity and valuation, two problems for a Haig-Simons tax that a realization-based income tax largely solves. One therefore might reject the Haig-Simons concept as irrelevant to the true, operational, income tax in favor of a normative definition of income that is transactional: Subject to certain exceptions, income equals gain or loss realized during the accounting period.¹¹² In that case, the reversal of a transaction would seem to operate with

¹¹⁰ The realization requirement is nowhere expressly stated in the Code. It is implicitly set forth in § 1001(a) (income is equal to amount realized less adjusted basis) and cognate provisions (principally §§ 1011 (adjusted basis is basis under § 1012, as adjusted under § 1016), 1012 (basis is cost), and 1016 (adjustments to basis)). Considered in the early years of the modern income tax to be constitutionally mandated, *see Eisner v. Macomber*, 252 U.S. 189, 211–12 (1920), the rule has since been downgraded to a principle of “administrative convenience.” *Helvering v. Horst*, 311 U.S. 112 (1940). *See also* Dodge, *supra* note 107, at 262 n.63 (noting that the realization requirement advanced in *Macomber* “was subsequently thrown out”). For a discussion of the centrality and endurance of the realization requirement, *see* Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 879–94 (1997). Further support for the non-incidental nature of the realization rule can be found in the fact that the tax expenditure budget has never included the non-taxation of unrealized gains as a tax expenditure.

¹¹¹ Note, however, that ability to pay as a criterion of taxing income presupposes that the owner of income before any tax is assessed is the one who produces it. The presupposition is not, strictly speaking, implied by the concept of taxing income.

On the purpose of the original income tax, *see* Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238, 2260 (2003) (reviewing EDWARD J. MCCAFFERY, *FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER* (2002)):

[T]he original hybrid [system of income and consumption taxation] was a deliberate decision to utilize different tax bases for different segments of the population. Consumption taxes failed to reach accumulated wealth and imposed a regressive burden on the poor and middle class. The progressive income tax, with its substantial exemption, was capable of balancing that burden without forcing the bulk of the population onto the income tax rolls.

¹¹² Among the exceptions to the rule that realization is a sufficient ground to assess tax are various nonrecognition provisions, such as I.R.C. §§ 351 (formation of a controlled corporation), 361 (corporate

the same force for the purpose of unwinding an income tax as it would for that of unwinding any transactional tax.

Yet, even if one rejects the accretion model of tax that follows from the Haig-Simons income concept, the notion that the income tax at bottom is a tax on transactions is mistaken. As distinct from the case of a true transactional tax, under the income tax, any particular realization event serves as a timing mechanism, not a criterion of tax.¹¹³ Even if the original transaction is unwound, the taxpayer still has income (or loss) that generally will be accounted for later.¹¹⁴ If *S*'s sale of *Blackacre* to *B* is unwound, the gain or loss that *S* does not recognize on the original sale will be preserved in *S*'s basis and accounted for at some future time. By contrast, a retail sales tax on an item will never be imposed on an unwound sale if the item is never subsequently sold. Likewise, a gift tax that is unwound will not be imposed later if the property is never gifted. More generally, a condition for the accrual of any tax liability under an excise tax is the transaction that is subject to tax. There is no tax waiting to be assessed on the gifted or sold item prior to the gift or sale.

One might counter that there is no more reason to believe that the income tax deferred in a current unwind will be collected in the future than that an unwound retail sales or gift tax will be collected later on. After all, it is possible that *Blackacre* will never be disposed of, in which case the tax on

reorganizations), 721 (partnership formation), 1015 (gifts of appreciated or depreciated property), and 1031 (like-kind exchanges of property). These provisions prevent gain recognition even where income technically is realized. Exceptions to the rule that realization is a necessary ground to impose tax include §§ 471 (inventory accounting), 475 (mark-to-market accounting for dealers in securities), and 1256 (mark-to-market accounting for certain forward, futures and option contracts). For an argument that the income tax is as reasonably characterized as a transactional tax measured by built-in gain or loss as it is a Haig-Simons tax that is assessed on transactions, see Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 1 (1993). See also Zelinsky, *supra* note 110, at 861 (arguing that realization is integral to the concept of income for the federal income tax).

¹¹³ See *Helvering v. Horst*, 311 U.S. 112, 116 (1940) (stating that the realization requirement is a rule of "administrative convenience," not constitutionally mandated, and nowhere citing *Eisner v. Macomber* as contrary authority).

¹¹⁴ A major exception to this rule is I.R.C. § 1014(a), which provides for a fair market value basis for property held at death. This provision, however, is widely recognized as an exception to the general rule of taxing income and is classified as a tax expenditure for federal budgetary purposes. See TAX POLICY CTR., PROJECTED INCOME TAX EXPENDITURE BUDGET 2004-10, at 3, http://www.taxpolicycenter.org/taxfacts/Content/PDF/project_taxexpend.pdf (listing the 1014(a) basis step-up rule as a tax expenditure). I.R.C. § 1014 may be repealed in whole or part in the near future. Under the law as currently scheduled to come into effect solely for 2010, § 1014 is repealed and replaced with the new I.R.C. § 1022, which generally provides for carry-over basis of assets held at death, subject to a limited basis credit that may be allocated among the decedent's assets.

disposition will remain uncollected. In that case, unwinding might reasonably be viewed as canceling the income tax, rather than as merely postponing it. As a practical matter, however, the income tax will be collected at some point, even if unwinding treatment applies. Consider the common case of the sale of depreciable, income-producing property. If the property is appreciated in *S*'s hands, the appreciation must have occurred because the expected value of the income stream from the property exceeds the expected value it had when *S* acquired it, taking into account allowable depreciation.¹¹⁵ The gain on sale that is currently avoided therefore is expected to appear in the form of an income stream greater in value than one would anticipate from property having *S*'s basis. *S* will have to take that income into account because her lower basis will preclude her from offsetting the income through depreciation deductions that *B* would have if the sale were consummated, or that *S* would have if the sale were reversed but not unwound.¹¹⁶

If the subject property is not depreciable, the gain will not be taxed, but only if the property is literally never disposed of. It seems reasonable to assume, however, that all investment property will be disposed of at some point if the time horizon is infinite. The real issue (in the cases of both depreciable and non-depreciable property) is therefore the deferral that results from the fact that the same dollar tax will be payable later than if the reversal is not accorded unwind treatment. Suppose *S*'s basis in *Blackacre* is \$100, and *Blackacre* appreciates to \$150. The appreciation reflects the fact that *Blackacre* is now expected to generate an income stream 50% greater than that expected when *S* bought it. *S* sells *Blackacre* to *B*, and the sale is later reversed. If unwind treatment is accorded to the reversal, *S*'s basis remains \$100. If not, her basis increases to \$150. If *S* then sells the property to a third party two years later for \$150, the real value of the tax liability is less than if the reversal had not been an unwind because of the two-year deferral. For example, if interest rates are 10% and *S*'s marginal tax rate at all times is 35%,

¹¹⁵ See I.R.C. § 167 (2006) (depreciation allowance).

¹¹⁶ Suppose that *S*'s purchase price were \$100 and that she properly depreciated the property to \$50. If the property is in fact worth \$75, that is to say that the expected income stream over its expected useful life is 50% greater than it "should" be, at least assuming (counterfactually) that the discrepancy between her basis and the property's fair market value were due solely to market fluctuations. In such a circumstance, the additional 50% will be taken into income during the remaining useful life of the property, if it is not sold. If it is immediately sold, the additional 50% is taken into income up front, on sale.

the present value of the tax liability due in two years on the \$50 of gain is just \$14.46,¹¹⁷ whereas it would be \$17.50 currently.

Although the case of unwinding dispositions of non-depreciable property raises the specter of tax deferral, the total deferral would be small if incentive effects are disregarded.¹¹⁸ Setting aside tax motivation, the net revenue result is a loss not greater than the real rate of return multiplied by the average aggregate annual deferral that results from according unwind treatment to such reversals. This result follows from the fact that, on an aggregate basis, gains and losses will equal out, except to the extent of real net economic growth.¹¹⁹ Thus, for every deferred gain transaction there will be an offsetting deferred loss transaction, apart from gains due to real economic growth. Estimates of the growth rate vary, but it appears to hover in the neighborhood of three percent.¹²⁰ Incentive effects can alter the picture significantly, but their role in this context is just a small part of the overall effect that incentives can have.¹²¹

3. *Unwinding Under a Non-Transactional Tax*

If one accepts that the fact of a reversal does not, by itself, negate the taxable event under an income tax, the question arises about the criteria that ought to apply in determining whether a reversal merits income tax unwind treatment. Unlike the transactional tax case, in which the reversal means one no longer may suppose that the taxable event has occurred, in the income tax case, the reversal does not imply that a tax on real income has not been imposed. What, then, is wrong with maintaining that the tax event should remain despite the formality of the reversal?

¹¹⁷ In general, $PV = FV / ((1 + r)^n)$, where PV is the present value of the future tax payment, FV is the dollar amount of the future tax payment, r is the applicable interest rate (expressed as a decimal), and n is the number of periods (expressed in years). See ROSEN, *supra* note 105, at 241. Under the facts of the example, $FV = \$17.50$, $r = 0.1$, and $n = 2$.

¹¹⁸ If taxpayers seek reversals only where unwind treatment would defer a gain, then the prospect of tax deferral in transactions involving nondepreciable property may be great. This subject is addressed in greater detail *infra* Part III.

¹¹⁹ See David Weisbach, *The (Non)Taxation of Risk*, 58 TAX L. REV. 1, 29 (2004). Technically, the result holds only in the case of a pure Haig-Simons tax, under which negative taxes apply when net income is negative. See *id.* Under the actual tax, and disregarding incentive effects, one would expect the net return on average to be negative because negative taxes generally are not assessed but deferred, see I.R.C. § 172 (2006) (net operating loss carryovers), and especially given the limitation on capital losses, see I.R.C. § 1211 (2006).

¹²⁰ See Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377, 387 & n.29 (1992).

¹²¹ Note further that a variety of limitations can apply to loss transactions. Typically these limitations will defer recognition of an otherwise realized loss to a later year. See, e.g., I.R.C. §§ 163(d) (investment interest), 170 (net operating losses), 465 (at-risk limitations), 469 (passive activity rules), 1211 (capital losses) (2006).

As a general matter, the answer would seem to hinge on the extent to which the same policy rationales that support the realization rule would support unwinding in the case of a reversal. These rationales traditionally have been identified as liquidity, or having cash on hand to pay the tax; valuation, or knowing the amount of income and therefore of tax due; and political acceptability, or being able to justify the imposition of tax despite the apparent lack of income where gain or loss is not “locked in.”¹²² From this perspective, the case for unwinding seems weaker than the case for non-taxation of accrued but unrealized gains. Valuation obviously is not a problem, as the reversal negates a transaction that already has been valued for tax purposes. Denying unwind relief also would seem to be more politically acceptable, if only because the taxpayer might be thought to have assumed the risk of incurring an unfunded tax liability when she entered into the first transaction, if that transaction later were reversed. Therefore, the only one of the standard policy justifications for the realization rule that would unambiguously support unwind treatment is liquidity. If proceeds received on a reversed transaction must be returned to a counter-party in the reversal, then the taxpayer may lack the funds to pay a tax liability if unwinding treatment does not apply.¹²³

Unfortunately, these considerations, while helpful, are unlikely to specify an unambiguously correct unwinding rule. At bottom, the question of whether the policy rationales that support the realization rule also support unwinding does not have a clear answer in the abstract. For example, whether the taxpayer can be said to have assumed the risk of tax in the event of a reversal is question-begging: The answer depends upon whether we think the taxpayer should be considered to have done so, and this, in turn, depends upon the kinds of judgments that go into the policy of making realization a condition to taxation in the first place. More generally, the judgment on whether unwinding under the income tax ever should be permitted, when made solely in terms of the criteria for taxing dispositions, depends fundamentally upon debatable policy assumptions that different people will find more or less

¹²² That is, deferral of tax until realization serves liquidity by ensuring a fund is available to pay tax, valuation by providing an authoritative value of the asset disposed of and therefore of the tax liability, and political acceptability by taxing only taxpayers who have “cashed out” of their investments. See Zelinsky, *supra* note 110, at 879–900.

¹²³ If, for example, A realized \$90,000 of gain on the sale of *Blackacre* to B, she would owe \$13,500 of tax, assuming a 15% rate of tax. If the sale were later reversed, she would have to return all the proceeds to B. If the reversal were not an unwind, she would have to come up with \$13,500 to satisfy the tax liability.

compelling.¹²⁴ This uncertainty is compounded by the problem of horizontal equity. Even if one determined that liquidity concerns were not significant enough to override a general policy of no unwinding relief, one still would have to confront the fact that the rule penalizes taxpayers for innocent mistakes. Thus, in the absence of unwinding relief, *S* will be treated worse than otherwise identical *Non-S* who never sells property to a third party.¹²⁵

The “rightness” of any given rule in the abstract, however, is not the only consideration relevant to shaping a well-conceived unwinding doctrine. A further and equally significant consideration is consistency. If one cannot decide whether liquidity or horizontal equity is sufficient to support a general policy of unwind treatment for reversals, one still may be able to decide which considerations should be relevant to unwinding, based upon how the law applies the same kinds of considerations that arise in cases parallel to it. This approach requires an account of unwinding that permits one to identify the ways in which it is similar to other areas of the tax law for which remedial rules have been developed. That is the path taken here. As explained in Part I.A, unwinding is the legal remedy for a certain kind of taxpayer error. Therefore, a natural place to look for guidance is in the tax treatment of other kinds of errors. As it turns out, a generally consistent strand of reasoning underlies the tax treatment of errors. Applying this line of reasoning to reversals permits an approach to the unwind case that is consistent with the reasoning applied more generally.

Moreover, there is much to be said in its own right for the tax law’s approach to other kinds of errors. As a general matter, the law assumes that individuals act in a rational, instrumental way, and it holds taxpayers to a standard of instrumental rationality in determining when relief should be available. When action is mistaken, but for “good reason,” the law generally provides relief if it can; it is less charitable when errors are the product of a failure to act on the basis of readily available information, lack of appropriate forethought, or wishful thinking. Naturally, an approach that relies on such distinctions requires the exercise of judgment in individual cases, and in this

¹²⁴ Compare Zelinsky, *supra* note 110 (arguing for realization as an essential criterion of income taxation), with Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722 (1990) (arguing that the time-value of deferral should be accounted for under the tax system).

¹²⁵ Louis Kaplow has argued that horizontal equity is an illusory norm that can largely be dispensed with in evaluating social policy, including tax policy. See Louis Kaplow, *Measures in Search of a Principle*, 42 NAT’L TAX J. 139 (1989). Whether or not Kaplow is correct in the case of higher-order policymakers, there seems little question that neither the IRS nor the courts can dispense with horizontal equity considerations.

respect, it lacks the clarity of a bright-line rule. By the same token, however, it seeks to classify cases on the basis of the same principle that operates at the most basic level in evaluating human conduct generally, which is the expectation that individuals act rationally.¹²⁶ In this respect, it offers the prospect of an unwinding regime that is substantively “correct.”¹²⁷

B. Tax Errors

The previous section argued that the connection between the taxable event and the justification for unwinding is attenuated under the income tax because the trigger for levying the tax does not count as the criterion for being subject to it. This section examines the law that applies in the two other income tax situations in which a remedy analogous to unwinding is available. In these cases, as in the unwind case, the question is whether a retroactive remedy should be available for an error of some kind, even though the conditions giving rise to the error do not mean that the taxpayer did not have the income (or loss) that was taxed in the original arrangement or transaction. Here, as in the unwinding case proper, the tax law has developed rules to mesh the problem of transactional consistency with the nature of a periodic income tax. The general approach taken in these settings is consistent, and because unwinding is part of the same family of situations, this approach offers a method for dealing with reversals, as well.

The analogous remedies are (1) equitable recoupment;¹²⁸ and (2) claim of right¹²⁹ together with its counterpart, the tax benefit rule.¹³⁰ Both have been partially codified.¹³¹ What they share is their role as remedies for errors that

¹²⁶ The assumption of rationality in action is adopted under virtually all modern approaches to the evaluation of human conduct, from Hobbes to classical economics. See THOMAS HOBBS, *LEVIATHAN* (4th ed., George Routledge & Sons 1894) (1651) (deriving political order from the assumption that individuals in the state of nature act rationally). In recent years a literature has emerged in “behavioral economics,” which seeks to understand the systematic bases in which individuals do not act rationally. See, e.g., Richard A. Epstein, *Behavioral Economics: Human Errors and Market Corrections*, 73 U. CHI. L. REV. 111 (2006). For purposes of this discussion, however, I assume that it is appropriate to judge individuals’ actions according to a standard of instrumental rationality.

¹²⁷ Part II.D addresses these issues in greater detail.

¹²⁸ See *United States v. Dalm*, 494 U.S. 596 (1990).

¹²⁹ See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

¹³⁰ See *Hillsboro Nat’l Bank v. Comm’r*, 460 U.S. 370 (1983).

¹³¹ See I.R.C. §§ 111 (codifying the “exclusionary side” of the tax benefit rule as well as its “inclusionary side” with respect to credits), 1311–14 (partially codifying and expanding the equitable recoupment doctrine); 1341 (partially codifying the claim of right doctrine) (2006).

are generally viewed as reasonable and therefore excusable.¹³² Equitable recoupment responds to the problem of logical inconsistency in taxpayer reporting.¹³³ The tax benefit rule and the claim of right doctrine typically respond to factual error that later is discovered or confirmed. As I argue below, in the income tax context unwinding should respond to reasonable mistakes regarding the possible efficacy of the taxpayer's chosen action to achieve the taxpayer's end. In each case, the effect of granting the remedy is an "undoing" of sorts.

The relationships among these errors can be expressed more formally in terms of a simple account of rational instrumental action.¹³⁴ Taken at the most general level, one can say that an agent, *A*, acts in an instrumental sense when she undertakes some action, *X*, under some set of conditions, *Y*, to achieve some end, *Z*. That is, *A* does *X* under *Y* to achieve *Z*. The action is rational if *A* understands what it means to do *X*, and *A* has good grounds for believing that she in fact is doing *X* under *Y*.¹³⁵ Critically, it is possible for *A* to make an error with regard to each element of this account and still be acting rationally. *A* may be mistaken about what it means to undertake *X*, she may be mistaken about whether she in fact undertook *X*, and she may be mistaken about the circumstances, *Y*, under which she undertook *X*.¹³⁶ Each of these mistakes has a corresponding remedy under the income tax.

¹³² As an example of the requirement of reasonableness with respect to the application of the tax benefit rule, see Treas. Reg. § 1.165-1(d)(2)(iii) (as amended in 1977), which specifies that the rule applies to unexpected recoveries of losses that were reasonably but erroneously deducted in a prior taxable year. Unreasonable factual errors giving rise to a prior claimed loss would not be subject to the tax benefit rule but, instead, would result in the taxpayer being subject to penalties if the errors were picked up on audit.

¹³³ See, e.g., *Rothensies v. Elec. Storage Battery Co.*, 329 U.S. 296, 299 (1946) (explaining that when a "single transaction or taxable event ha[s] been subjected to two taxes on inconsistent legal theories . . . what was mistakenly paid [can be] recouped against what was correctly due").

¹³⁴ See generally H.A. SIMON, *MODELS OF BOUNDED RATIONALITY* (1982).

¹³⁵ A further requirement would be that doing *X* under *Y* is an effective way to achieve *Z*. As explained below, the law generally does not question the taxpayer's concept of the efficacy of a particular means to reach a given end, and I have found no case of a reversal based on a failure to understand a causal mechanism.

The concept of instrumental rationality has been recognized at least since Hobbes. See Guy Haarscher, *Perelman and Habermas*, 5 *LAW & PHIL.* 331, 336 (1986) ("[R]eason is, in the Hobbesian sense, only 'instrumental' (reason of the means, not of the ends)."). Max Weber's concept of purposive rationality rests on the same general understanding of instrumental reason. See 1 MAX WEBER, *ECONOMY AND SOCIETY* 24 (Guenther Roth & Claus Wittich eds., Ephraim Fischhoff et al. trans., Univ. Cal. Press 1978) (1956).

¹³⁶ *A* may even be mistaken about the desirability of the end, *Z*, that she chooses to attain by means of undertaking *X* under *Y*. The rationality of having end *Z* goes to what might be called substantive rationality and is outside the scope of a discussion of (mere) instrumental reason. Whether it is possible to articulate reasons for the various *Z*'s that agents may have is perhaps the principal question of moral philosophy.

1. *Logical Error—Equitable Recoupment/Mitigation*

The doctrine of equitable recoupment, and its partial codification (and expansion) in the mitigation sections of the Code,¹³⁷ deals with problems arising from internally inconsistent reporting.¹³⁸ Equitable recoupment permits a taxpayer to offset against the proper assessment of tax (or permits the government to offset against a proper claim for refund) amounts collected (or owed) with respect to the same transaction as a result of its being taxed under another provision on the basis of assumptions inconsistent with its treatment under the first provision. The doctrine applies even if the limitations period has closed for assessment under the latter provision.¹³⁹ The inconsistency must arise as a result of a proceeding brought by the other party that successfully challenges the initial treatment of the amount in question. That is, equitable recoupment operates as a defense to the statute of limitations; it does not operate as a basis either for jurisdiction or for a claim for refund or for taxes due.¹⁴⁰ In terms of the model of rational instrumental action explained above, equitable recoupment concerns errors about what it means to claim to undertake X. When a taxpayer adopts internally inconsistent positions with regard to a particular event, X, she fails to claim to undertake X. In the ordinary case, this failure is not excusable; equitable recoupment and mitigation concern the limited circumstances in which it is excused.

As an example, consider an estate that fails to include in the final income tax return of its accrual-method decedent amounts that are owed but not yet paid to her at the time of death.¹⁴¹ Assume that the estate properly included the amounts in the computation of the decedent's gross estate for estate tax purposes, but that, consistent with not including the amounts for income tax purposes, the estate did not take an estate tax deduction for income taxes owed thereon.¹⁴² In a successful deficiency proceeding brought by the IRS to recover the income tax owed on the accrued but unpaid income tax liability, the estate could invoke equitable recoupment to offset (but not to obtain a refund for) the income tax deficiency with the amount by which the estate tax

¹³⁷ I.R.C. §§ 1311–14 (2006).

¹³⁸ See BITTKER & LOKKEN, *supra* note 34, ¶ 113.10.

¹³⁹ *Rothensies v. Elec. Storage Battery Co.*, 329 U.S. 296, 300 (1946) (“As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages . . .”). However, the Court in *Rothensies* did not allow the taxpayer to get around the statute of limitations. See *id.*

¹⁴⁰ *United States v. Dalm*, 494 U.S. 596, 608–11 (1990).

¹⁴¹ *Bull v. United States*, 295 U.S. 247, 252 (1935).

¹⁴² I.R.C. § 2053(a)(3) (2006).

should have been reduced by reason of the payment of the income taxes on the improperly non-accrued payments to the decedent.

In the opposed case, the IRS may assert equitable recoupment to offset a successful claim for refund with a deficiency resulting from conforming the tax treatment of the same item under another provision with its treatment under the refund claim. Thus, in the previous example, the IRS would be able to invoke equitable recoupment on the income tax deficiency if the taxpayer sought an estate tax refund under a timely claim for refund of excess estate tax paid. In either case, the offset would be available regardless of whether the statute of limitations had run on the inconsistent inclusion or deduction, but it would only be available if the underlying claim were timely and properly filed¹⁴³ and only as an offset to that claim. Equitable recoupment cannot serve as its own basis for suit or recovery, nor can it operate to open an otherwise time-barred claim.¹⁴⁴

The mitigation rules of the Tax Code operate with similar effect, though they apply to a broader range of inconsistencies and they operate to open the otherwise closed tax year.¹⁴⁵ For example, where the inconsistency involves two taxpayers lacking an “identity of interest,” the equitable recoupment doctrine will almost never apply, but the mitigation provisions often will.¹⁴⁶ Thus, a successful claim by a corporate taxpayer that amounts it distributed to the parent member of its affiliated group constitute deductible interest payments¹⁴⁷ rather than non-deductible dividends would provide a basis for the government’s assertion of a deficiency against the parent if it reported the

¹⁴³ See BITTKER & LOKKEN, *supra* note 34, ¶ 113.10.

¹⁴⁴ *Dalm*, 494 U.S. at 611.

¹⁴⁵ See BITTKER & LOKKEN, *supra* note 34, ¶ 113.9. Among the cases for which the mitigation rules have ousted the courts’ equitable jurisdiction are those involving inconsistencies with respect to the same tax. See I.R.C. § 1312. For example, consider a taxpayer seeking a refund for erroneous recapture of excess depreciation on the sale of an asset. Suppose that the basis of the refund claim is that the asset was subject to straight-line rather than accelerated depreciation, with the consequence that the adjusted basis of the asset at the time of sale was higher than initially reported. If the taxpayer prevails on the refund claim, the IRS could invoke the mitigation rules to require as an offset to the refund claim the inclusion of excess depreciation deductions taken in prior years with respect to the same asset, on the basis that the proper method was straight-line depreciation, even if the prior years were otherwise closed. See *id.* § 1312(7).

¹⁴⁶ Compare BITTKER & LOKKEN, *supra* note 34, ¶ 113.10 (noting that the same taxpayer requirement applies to equitable recoupment), with I.R.C. §§ 1312(b)(5), 1312(b)(6) (2006) (applying mitigation provisions to certain related taxpayers).

¹⁴⁷ See I.R.C. § 163 (2006).

receipts as deductible dividend income,¹⁴⁸ even if the statute against the parent had run.¹⁴⁹

The equitable recoupment doctrine and mitigation provisions provide defenses to the statutory bar on opening closed years for a particular type of excusable inconsistency. The inconsistency is purely internal, or logical. It concerns the taxpayer's own account of what is the case for tax purposes. The exception is particularly narrow because logical consistency ordinarily depends upon nothing that is outside of the taxpayer's control. Hence, in the ordinary case, inconsistent reporting—claiming one rule applicable to the same item for one purpose and a contrary rule for another purpose—would not entitle the taxpayer to any relief whatever.¹⁵⁰ For example, an estate may not file an income tax return treating an accrued but unpaid item of an accrual-method decedent as not part of the estate's income (thereby reducing the income tax of the estate), and file an estate tax return that treats the same item as subject to income tax for estate tax purposes (thereby reducing the size of the estate by the income tax due on the item), even if both positions are reasonable.¹⁵¹ The bar would, or at least should, apply whether or not there is substantial authority for both positions, because they are logically inconsistent. Equitable recoupment and mitigation permit relief for the inconsistency in the narrow case where it arises from another party's successful recharacterization of the tax consequences of the taxpayer's actions. The inconsistency is excused because, as the product of another party's action, it could not have been foreseen. It arises from the correction initiated by the other party of an error in the taxpayer's position.¹⁵²

¹⁴⁸ See I.R.C. §§ 243(a), 243(b)(2) (2006).

¹⁴⁹ See BITTKER & LOKKEN, *supra* note 34, ¶ 113.10.

¹⁵⁰ See *id.* Ordinarily relief will be barred by the doctrine of equitable estoppel, which prevents the taxpayer from asserting a position if the taxpayer has benefited from a contrary position with respect to the same item in a closed year. See *id.* The rule applies without regard to whether the later position is correct. See *id.*

¹⁵¹ See, e.g., *Lewis v. Comm'r*, 18 F.3d 20, 26 (9th Cir. 1994) (stating that the duty of consistency "prevents a taxpayer who has already had the advantage of a past misrepresentation—in a year now closed to review by the government—from changing his position and, by claiming he should have paid more tax before, avoiding the present tax"). See generally BITTKER & LOKKEN, *supra* note 34, ¶ 4.3.7 (discussing the taxpayer's duty of consistency and citing cases, including *Lewis*).

¹⁵² Note that the initial error itself will always have been the taxpayer's because the taxpayer, and not the government, reports the taxpayer's income. It is open to both the taxpayer and the government, however, to correct previously reported errors, and it is this correction that gives rise to the inconsistency.

2. *Factual Error—Tax Benefit Rule/Claim of Right*

The tax benefit rule (TBR) and claim of right doctrine are judge-made equitable tax remedies, each now partially codified,¹⁵³ designed to preserve transactional consistency within the framework of a periodically assessed income tax. The TBR requires taxpayers to include in income in the current year any amounts deducted or otherwise treated as providing a tax benefit in a prior year, to the extent that events or arrangements discovered in the current year are “fundamentally inconsistent” with the reporting of the prior benefit.¹⁵⁴ The claim of right doctrine applies in the converse situation, where an amount previously included is deducted or paid out as a result of a similar later event or arrangement. Under claim of right, the taxpayer may take a deduction for all or a portion of the amount paid in the later year.¹⁵⁵ In both cases, the remedies involve a form of retroactive taxation. In terms of the model of instrumental action described above, TBR and the claim of right doctrine involve errors about whether the taxpayer really undertook action X.

a. *Tax Benefit Rule*

The TBR has been described as designed “to achieve rough transactional parity . . . and to protect the Government . . . from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous.”¹⁵⁶ Frequently recurring TBR situations are the inclusion of a prior bad debt deduction on unexpected repayment of the debt¹⁵⁷ and the inclusion in income of amounts previously deducted as losses under § 165 when the amounts have been unexpectedly recovered.¹⁵⁸ In these cases the taxpayer has enjoyed a tax benefit based on an assumption in the prior year that turns out in the later year to have been erroneous. When the error becomes manifest, the previously enjoyed benefit must be taken into income. As a general matter, the tax rate that applies to the

¹⁵³ See I.R.C. §§ 111(b) (codifying basic TBR with respect to credits), 1341 (codifying claim of right for a wide range of cases) (2006).

¹⁵⁴ *Hillsboro Nat'l Bank v. Comm'r* 460 U.S. 370, 383 (1983). For example, a casualty loss may be properly deducted in Year 1 and then be unexpectedly recovered in Year 2. See Treas. Reg. § 1.165-1(d)(2)(iii) (1977). As explained below, when the previous error provided no tax benefit, no current inclusion is generally required. See I.R.C. § 111(a) (2006).

¹⁵⁵ *N. Am. Consol. Oil Co. v. Burnet*, 286 U.S. 417, 424 (1932); see also I.R.C. § 1341(a)(2) (2006) (noting the availability of a deduction in claim of right situations).

¹⁵⁶ *Hillsboro Nat'l Bank*, 460 U.S. at 383.

¹⁵⁷ I.R.C. § 166 (2006).

¹⁵⁸ See Treas. Reg. § 1.165-1(d)(2)(iii) (2007).

later inclusion is that in effect in the year of the inclusion. A narrow exception applies to the extent that the original benefit produced no reduction in the prior year's tax, in which case the current inclusion triggers no tax to the same extent.¹⁵⁹ Thus, the general rule for TBR situations is something between true transactional treatment and fully separate treatment. Complete transactional treatment would require amendment of the prior year's return and imputation of interest, if not assessment of penalties, on the underpayment. Completely separate treatment would require evaluation of the later-year event without regard to the nature of the original transaction, whereas the TBR generally requires preserving the character of the tax benefit (e.g., capital vs. ordinary) and will even require an inclusion where there is no actual recovery in the later year.¹⁶⁰

It is possible to divide TBR situations into two generic types. In the first type, the taxpayer's own change of course triggers an inclusion in the year of the change. This case is discussed in the next section below.¹⁶¹ In the second type, in the later year either an involuntary event (from the taxpayer's perspective) or a discovery that is inconsistent with the tax benefit taken in the prior year triggers an inclusion in the later year. A typical example of an inconsistent discovery leading to a later inclusion would be the taxpayer's casualty loss deduction¹⁶² in Year 1 for an item she reasonably believed was permanently lost in that year, followed by her discovery in a later year that the item in fact had been in her possession at all times. In this instance, all that has changed is the taxpayer's assumed knowledge of the state of affairs that was thought to support, but in fact did not support, the claimed tax benefit. No unexpected change to the state of affairs itself occurs.

In the case of an inconsistent involuntary event, an apparent reversal of the transaction that gave rise to the tax benefit in the prior year takes place in the later year, triggering an inclusion. In this setting, the TBR operates similarly to an unwind that applies to a reversal. The initial transaction is retroactively recharacterized, and the tax effects of the recharacterization are taken into

¹⁵⁹ See I.R.C. § 111 (2006); see also *infra* note 193.

¹⁶⁰ Prior to *Hillsboro National Bank*, the question of whether the TBR applied only when the taxpayer enjoyed a "recovery" of an inconsistently treated item was unsettled. See *Hillsboro Nat'l Bank*, 460 U.S. at 377–80. *Hillsboro National Bank* clarified that an actual recovery was not necessary to trigger the TBR. See *id.* at 381. Rather, the rule applies whenever an event "fundamentally inconsistent" with the prior tax benefit occurs. See *id.* at 383; see also BITTKER & LOKKEN, *supra* note 34, ¶ 5.7.1 (discussing the transactional nature of the TBR).

¹⁶¹ See *infra* Part II.B.3.

¹⁶² See I.R.C. § 165(h) (2006).

account, at least in part, in the later year. The difference between a true unwind, as defined in Part I, and this situation—and the reason I use the term “apparent reversal”—is that here the inconsistent event is in a sense embedded in the first transaction (at least from the taxpayer’s perspective), rather than the result of a separate choice to reverse the outcome. In effect, the later-year inclusion results from the correction of an error in the initial characterization and not from an independent choice to reverse the transaction.¹⁶³ This circumstance makes the case conceptually closer to the mistake-of-fact situation just discussed than to the unwinding case proper, in which the reversal is independent of the initial transaction.

Consider, for example, one of the best-known applications of the TBR, *Alice Phelan Sullivan Corp. v. United States*.¹⁶⁴ The taxpayer, a corporation, donated separate parcels of property in 1939 and 1940 to a charitable organization. The contributions were conditioned on the organization’s use of the property for religious or educational purposes, but the transfers were treated as completed gifts at the times of contribution, and the taxpayer took charitable deductions with respect to them at those times in amounts equal to their then-fair market values. In 1957, the properties were no longer used for the specified purposes, and the organization returned them to the taxpayer, which reported the reconveyances as returns of capital. Under a return of capital theory, the reconveyances would escape tax because the taxpayer had a basis in the property at the time of the contribution sufficient to support the deduction, and the return would simply effect a restoration of the basis.¹⁶⁵ On

¹⁶³ Other examples of this kind of quasi-reversal include the sale of S corporation stock to a non-stockholder prior to permitting other shareholders to exercise a right of first refusal, as provided in the corporation’s organizing documents, see, e.g., Priv. Ltr. Rul. 77-48-034 (Aug. 31, 1977) (holding that a putative transfer of stock to trust, later held void *ab initio* by state court, did not terminate corporation’s S election despite the fact that the trust was a prohibited shareholder), and the subsequent-year return, required under state law, of an unlawful dividend. *Knight Newspapers v. Comm’r*, 143 F.2d 1007 (6th Cir. 1944) (analyzing transaction created at time of dividend distribution as a constructive trust).

¹⁶⁴ 381 F.2d 399 (Cl. Ct. 1967); see also Rev. Rul. 76-150, 1976-1 C.B. 38 (citing *Alice Phelan* for proposition that “recovery of charitable contribution has been held by the courts to fall within the scope of [the income tax] regulations”).

¹⁶⁵ See I.R.S. Gen. Couns. Mem. 37,175 (June 23, 1977) (explaining return of capital theory); Rev. Rul. 70-86, 1970-1 C.B. 23 (applying return of capital theory, but not by name, to same-year property tax rebates). The very favorable rules for charitable contributions provide an additional overlay to the analysis. Under the law in effect in 1939 and 1940, and continuing for many types of property today, taxpayers could deduct the full fair market value of property contributed to qualifying organizations, even if it exceeded their basis. See I.R.C. § 170(a)(1) (2006) (permitting a deduction for “any charitable contribution” as defined in the statute and associated regulations); Reg. § 1.170A-1(c) (2007) (stating that the amount of the contribution is the fair market value of the property at the time of contribution, reduced as otherwise provided). One therefore could argue that for purposes of the charitable contribution deduction, a return of capital theory would presumptively

audit the IRS held that under the TBR the reconveyances required inclusion of the amounts originally deducted, but at the 1957 corporate tax rate of 52%, not the rates in effect when the taxpayer transferred the properties—18% in 1939 and 24% in 1940.¹⁶⁶

In the Court of Claims, the taxpayer abandoned its return of capital theory, acknowledging, apparently, that the theory was inapplicable in light of the deductions claimed in 1939 and 1940.¹⁶⁷ Instead, it agreed with the government that the TBR applied, but it disagreed over precisely how. Relying on Court of Claims precedent,¹⁶⁸ the taxpayer argued that the inclusions in 1957 should be taxed at the same rates that had applied to the deductions in the prior years rather than at the 1957 rate. In other words, the taxpayer sought completely transactional treatment.

The court ruled for the government. It acknowledged that prior precedent supported the taxpayer,¹⁶⁹ but it also found the reasoning of that precedent questionable and inconsistent with more-recent authority, which supported the IRS's proposed treatment.¹⁷⁰ The more-recent authority held that the taxpayer's approach would conflict with the annual accounting principle, which, absent express statutory override, must treat each taxable year as a separate taxable unit.¹⁷¹

The effect of the court's ruling was to treat the return as something between a separate, fully taxable transaction and one that negated the effects of the initial transfer entirely. Full transactional consistency would have required the reconveyances to be nullified in their entirety, in effect reversing deductions erroneously taken in 1939 and 1940. Presumably the taxpayer recognized that

treat the taxpayer's basis as equal to fair market value, since it in effect got basis credit for this amount on the original contribution.

¹⁶⁶ *Alice Phelan Sullivan Corp.*, 381 F.2d at 400 n.3.

¹⁶⁷ *Id.* at 400. Another possibility is that the taxpayer recognized that any built-in gain in the property as of the time of the original contributions would have been taxable on the return, since the return of capital theory would only shield the returns to the extent of the taxpayer's previous basis.

¹⁶⁸ *Perry v. United States*, 160 F. Supp. 270 (1958).

¹⁶⁹ *Alice Phelan Sullivan Corp.*, 381 F.2d at 400.

¹⁷⁰ The court held that the prior precedent failed to respect the annual accounting principle, especially as articulated in subsequent cases, including U.S. Supreme Court cases. *Id.* at 401.

¹⁷¹ *Id.* at 403; see also I.R.S. Tech. Adv. Mem. 92-36-003 (May 22, 1992) (treating the reconveyance to an estate of a restricted charitable gift on failure to satisfy the restriction as a separate transaction not requiring reversal of the charitable gift for purposes of the estate tax, which lacks an analog to the TBR). The IRS also held that the return was not subject to income tax, because it fell under the exclusion from gross income for devises. See I.R.C. § 102(a) (2006).

the established law on the TBR foreclosed this result.¹⁷² Otherwise, the taxpayer could have argued that, because the 1939 and 1940 years were closed in 1957, no disallowance of deductions taken in those years would be available to the IRS.¹⁷³ Conversely, it appears that the IRS viewed the reconveyances as something more than bare transfers of property to the taxpayer for no consideration. That analysis would have required inclusions in 1957 equal to the fair market values of the properties at that time.¹⁷⁴ Instead, all parties treated the properties as having the same values at all times. There is no evidence to suggest that either party believed the properties' values not to have changed, and it seems implausible to suppose that these values did not change.¹⁷⁵

Alice Phelan Sullivan illustrates why inconsistent-event cases are not unwinds proper. The unwind analysis is predicated on the notion that an event or condition is discovered that thwarts the purpose of the initial transaction. That is, the transaction itself is not in question; the reason for doing it is. Although *Alice Phelan Sullivan* appears to be about a mistake regarding what happened after the initial transaction, it is better characterized as involving an error in the characterization of that transaction itself, which characterization was demonstrably inaccurate at the time, even if for good reasons.¹⁷⁶ As noted, the taxpayer in *Alice Phelan Sullivan* specified the consequences of disqualifying uses of the properties in the original transfer deeds of 1939 and 1940. The taxpayer therefore was incorrect, as an economic though not a legal matter, in valuing the contributions on the dates of transfer at the fair market values of the properties. An accurate tax accounting of the transactions, though infeasible as a practical matter, would have treated the contributions as partial, discounting their amounts by the probability, as of the date of the

¹⁷² See BITTKER & LOKKEN, *supra* note 34, ¶ 5.7.

¹⁷³ If full unwinding applied and for some reason the statute of limitations were not held to bar the tax, the result would have been worse for the taxpayer, as interest would be deemed to have accrued on the deficiency during the interim. See Banoff, *Unwinding*, *supra* note 1, at 983.

¹⁷⁴ See I.R.C. § 61(a) (2006) ("[G]ross income means all income from whatever source derived . . ."); *Helvering v. Bruun*, 309 U.S. 461 (1940) (holding that the cancellation of a real property leasehold resulted in gross income to the lessor to the extent of the fair market value of real property improvements constructed by the lessee); *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (holding that the statutory predecessor of the preceding language included windfall gains).

¹⁷⁵ The opinion contains no discussion of the question of valuation.

¹⁷⁶ See William A. Klein, *Tailor to the Emperor with No Clothes: The Supreme Court's Tax Results for Deposits and Advance Payments*, 41 UCLA L. REV. 1685, 1690–91 (1994) (noting that a focus on cash receipts as a measurement of income may be consistent with sound principles of tax administration, even though it generates economically inaccurate results).

original contributions, that the properties would be returned because of disqualifying use. Under such an approach, the transactions would have been fully accounted for as of the initial dates of contribution, with no further tax consequences on return.

For example, suppose the corporation's adjusted basis in one of the properties had been \$40, the fair market value had been \$100, and the probability of return over, say, 30 years were 30%.¹⁷⁷ Instead of treating the donation as a \$100 charitable contribution subject to possible return, under this method it would be treated as a \$70 contribution. The corporation would retain a separate basis item equal to 30% of its basis in the property, or \$12. Any return would be a nontaxable transaction, with the property receiving a \$12 basis. If the property was not returned during the 30 years, the corporation would take a \$12 loss. On average, the result would be the same as if the full deduction were taken and the transaction were subject to the TBR as in the actual case.¹⁷⁸

The point of these observations is not to suggest that the taxpayer should have discounted the contributions because of the return possibility; that is not a workable tax rule. The point is to highlight that the error that appears to result from a change in circumstances is in fact due to a discrepancy, existing at the outset, between the actual transaction and the transaction as reported. It is an error of fact, if not a mistake proper: The transaction, though reported as complete, was a contingent transfer. However, neither this type of case nor the more straightforward case of factual error that is later discovered and reversed involves a genuine unwind. Rather, both involve a discrepancy between the initial characterization of the transaction (of "what is the case") and what it in

¹⁷⁷ Thirty years is chosen as a reasonable estimate of the period over which the prospect of return has meaningful economic value as of the time of contribution. The present value of a return sometime after 30 years is negligible under reasonable assumptions about interest rates. See, e.g., Treas. Reg. § 1.1031(a)-1(c)(2) (2007) (treating the exchange of a fee interest in land for a leasehold of thirty or more years as an exchange of properties of "like kind" for purposes of I.R.C. § 1031(a)).

¹⁷⁸ On average, in ten identical contributions, there would be three returns. Under the approach described above, each contribution would generate a \$70 deduction for a total of \$700. The three returns would be nontaxable, but the net \$180 built-in gain ($3 \times (\$100 - \$40)$) would be realized when the properties were later sold. This is the same result that would apply if seven of the properties were given outright and the remaining three were sold.

In practice, the discounting computation would be considerably more complex because it would account for the time value of a delayed return. For example, a more accurate discounting would determine the likelihood in any given year of return and permit an amortization of the basis over time as long as there was no return. This observation merely highlights that the initial characterization was appropriate as a practical matter.

fact was at the time. In the inconsistent event case the second transaction resembles a reversal, but only because the first transaction is inaccurately (though appropriately) characterized at the time it occurs.¹⁷⁹

b. Claim of Right

Claim of right applies in the case opposed to the TBR, where the taxpayer later discovers that it is not entitled to an amount that it previously included in income under a “claim of right.” In this opposite case, the taxpayer has, or should have, included an amount in income in a prior year because the taxpayer’s right to it in that year was sufficiently unrestricted to count as an accession to wealth.¹⁸⁰ In the later year it turns out that the taxpayer was not entitled to the income item in the prior year, and the taxpayer typically is entitled to relief in the later year to reflect the erroneous inclusion.¹⁸¹ Like the TBR, claim of right arises when the initial characterization turns out to be factually erroneous.

Not surprisingly, reported claim of right cases typically involve the first transaction, where the taxpayer is resisting inclusion of an amount that the taxpayer knows may be subject to return at a later date. The Supreme Court first articulated the doctrine in such a case, *North American Oil Consolidated v. Burnet*.¹⁸² The question was whether the taxpayer was required to include in income in 1916 an amount that the taxpayer received in that year, but reasonably believed might be subject to return in a later year, pending the outcome of ongoing litigation. The Court held that the amount was includible in 1916 and not when the taxpayer ultimately prevailed, in 1922, because the amount was not subject to any restriction on disposition in 1916. The Court went on to hold that, had the taxpayer lost, it “would have been entitled to a deduction from the profits of [the year in which repayment were required], not from those of any earlier year.”¹⁸³

¹⁷⁹ The infeasibility of discounting the amount of the contribution to reflect the probability of a return is reflected in the regulations’ granting of a full deduction where the possibility of the occurrence of a subsequent event that would defeat the gift is “so remote as to be negligible.” Treas. Reg. § 1.170A-1(e) (2007).

¹⁸⁰ See *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932).

¹⁸¹ No deduction will be allowed, however, where the payment in the later year does not represent an economic loss to the taxpayer. See, e.g., I.R.S. Tech. Adv. Mem. 6907110540A (Mar. 31, 1966) (holding that a corporate distribution based on mistaken assumptions followed by a “good faith” return of the distribution to the corporation was treated as a dividend to the extent of the corporation’s earnings and profits and a separate contribution to corporate capital, and not as an inclusion followed by a deduction).

¹⁸² 286 U.S. 417 (1932).

¹⁸³ *Id.* at 424.

Like the TBR, the claim of right doctrine in theory can apply in mistake of fact as well as in “inconsistent event” cases.¹⁸⁴ Thus, both an amount included in income based on a mistake about ownership and an amount actually received by the taxpayer but subject to later return would be deductible in the year the mistake were discovered or the year of return.¹⁸⁵ Moreover, as in the TBR cases described above, the errors in claim of right cases generally should be understood as mistakes of fact regarding the initial transaction, regardless of whether the mistake appears as a genuine mistake of fact or as a quasi-reversal. In both circumstances, a discrepancy between the transaction as initially reported and the transaction that actually occurred is the cause of the erroneous reporting in the prior year.

Unlike the TBR, the claim of right doctrine has been codified for a wide range of cases. As originally formulated, the doctrine permitted only a deduction in the later year, without regard to whether the deduction was useful or whether the tax rate that applied to the deduction matched that on the original inclusion.¹⁸⁶ In 1954, Congress enacted Section 1341 in order to remedy the injustices that were perceived to arise from these limitations.¹⁸⁷ Under § 1341, when the taxpayer is otherwise entitled to a deduction because of a prior, erroneous claim of right, and certain other conditions are met,¹⁸⁸ the taxpayer has the option of taking a deduction for the amount of the payment in the later year or reducing her tax in the later year by the amount of tax that would not have been paid in the prior year had the amount been properly reported.¹⁸⁹ Apart from the fact that the government pays no interest on the overpayment, the statutory relief amounts to full transactional consistency

¹⁸⁴ See *Cinergy Corp. v. United States*, 55 Fed. Cl. 489, 500 (2003) (“Claim of right cases tend to coalesce around some dispute over the ownership of income or a mistake of fact, deriving, for example, from a quarrel over the ownership of income producing property, the misapplication of a contract provision, or the payment of funds under a contingency based upon business expectations that were thought to, but actually did not, materialize.”).

¹⁸⁵ I.R.C. § 461 (2006) (deduction in year of repayment). It is possible, though difficult to imagine, a case in which the taxpayer would erroneously include an amount in income based on a mistake of fact. In such a case the deduction should be available on discovery of the error.

¹⁸⁶ *N. Am. Oil Consol.*, 286 U.S. at 423–24; see also *United States v. Lewis*, 340 U.S. 590, 591–92 (1951).

¹⁸⁷ See Pub. L. No. 83-591, § 12 (1954). According to the House Ways and Means Committee report, the provision was adopted to address the concern that in many claim of right cases, “the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year.” H. Rep. No. 1337, at 86. The \$3,000 floor was adopted “for administrative reasons.” *Id.*

¹⁸⁸ These conditions include that it must have “appeared” that the taxpayer had an unrestricted right to the item, I.R.C. § 1341(a)(1) (2006), and that the amount of the deduction in the current year exceeds \$3,000, *id.* § 1341(a)(3).

¹⁸⁹ *Id.* §§ 1341(a)(4), 1341(a)(5).

whenever the credit is available and is more favorable than the deduction to the taxpayer, and to better than transactional consistency when the credit is less favorable.

Like the TBR, the claim of right doctrine as originally formulated is a halfway house between full transactional consistency and the annual accounting principle. Full consistency would require amendment of the prior year's return to reflect that the amount was not, after all, held by the taxpayer as its income in that year. Subject possibly to the bar of the statute of limitations, the reduction presumably would entitle the taxpayer to a refund in the current year of the amount of excess tax paid, with interest. Conversely, full application of the annual accounting principle would not necessarily afford a tax benefit in the year in which the erroneous nature of the prior treatment came to light. Rather, the availability of the deduction would depend upon whether an independent statutory basis for it otherwise applied to the event.¹⁹⁰

c. Observations on the TBR and Claim of Right

The TBR and the claim of right doctrine deal with the same basic problem: what to do when an inconsistency arises between what the taxpayer reports as having happened and what actually happened, and the inconsistency is excusable.¹⁹¹ As distinct from equitable recoupment and mitigation, the error has to do with an inconsistency between what is stated to be the case and what is in fact the case, not between what is stated to be the case for one purpose and what is stated to be the case for another. Transactional consistency therefore is differently preserved. It involves re-casting the prior event so that its treatment is consistent with the actual facts. By contrast, where the failure to report the initial transaction correctly is not excusable, no recast occurs. Thus, an unjustified prior deduction has no bearing on the treatment of the associated later-year inclusion when the error is discovered. It will be taxed based on its "own" character. Similarly, an unjustified prior inclusion will not automatically authorize a deduction in the current year when the amount is

¹⁹⁰ See BITTKER & LOKKEN, *supra* note 34, ¶ 6.33 (noting the government's apparent concession to the propriety of a deduction in the later year even where an independent statutory basis therefor is lacking). A typical case would be the return in the current year of a portion of the amount received in a prior year on sale of personal property. *Id.*

¹⁹¹ Excepting the case of a voluntary change of course is "fundamentally inconsistent" with the earlier benefit taken. This case constitutes a taxpayer-unfavorable unwind, though it has been analyzed under tax benefit principles for reasons explained below. See *Hillsboro v. Comm'r*, 460 U.S. 370, 371 (1983); see also *supra* note 160.

paid out or lost. A deduction would apply only if the later-year event itself supports it. Further, the taxpayer will or should be subject to penalty in the first case and is entitled to no relief in the second.¹⁹²

By contrast, apart from the vagaries of rate fluctuations (and setting aside the more generous relief Congress has made available by statute¹⁹³), neither a penalty to the taxpayer in the TBR case nor a windfall for the government in the claim of right case arises from having gotten the earlier year wrong. The taxpayer simply recharacterizes the earlier event in light of the actual facts. To be sure, the remedy is not fully transactional in that it does not reopen the prior year, but this limitation reflects administrative considerations and does not systematically favor or disfavor either the taxpayer or the government. Depending upon the direction of tax rates, there is as likely to be a benefit as a detriment to the taxpayer from applying current-year rates, and in both the TBR and the claim of right case, interest does not apply to the under- or over-payment.

3. *Purposive Error—Contextual Mistake*

As discussed above, a still different kind of case arises when the taxpayer is mistaken about the efficacy of her course of action to achieve a particular purpose. This error is not an inconsistency in characterizing what the taxpayer did or an inconsistency between what the taxpayer in fact did and what she reported she did. It is an inconsistency between her understanding of the consequences of what she did and its actual consequences. It therefore relates to the conditions assumed to obtain when the transaction was entered into,¹⁹⁴

¹⁹² The fact that the taxpayer may be better off in having taken an unjustified benefit results from low audit rates and, in general, the tax system's reliance on self-reporting and policing. If all returns were audited and later errors discovered, the taxpayer would be subject to penalties on all unjustified prior-year benefits taken.

¹⁹³ See I.R.C. §§ 111(a) (2006) (applying a zero rate to the later-year recovery for the special case in which the prior benefit did not reduce the amount of tax); 1341(a) (providing a choice between prior-year and current-year rates for calculating the amount of relief for certain erroneous prior inclusions).

¹⁹⁴ Technically, it also could relate to the taxpayer's understanding of the mechanism by which what she did would effect her end. This kind of general knowledge is generally presumed in the tax law, as exemplified, for instance, in the concept of a "necessary" expenditure as defined for purposes of the deduction for ordinary and necessary business expenses under I.R.C. § 162(a). In all but the most unusual of circumstances, an expenditure will be treated as "necessary" as long as the taxpayer can demonstrate that the expenditure was undertaken for a business purpose. See *Welch v. Helvering*, 290 U.S. 111, 113 (1933); see also BITTKER & LOKKEN, *supra* note 34, ¶ 20.3 (stating that *Welch* interprets the statutory term "necessary" to "require[] no more than that expenses be 'appropriate and helpful' in developing the taxpayer's business") (quoting *Welch*, 290 U.S. at 113).

not to the transaction itself. In terms of the model of instrumental rationality sketched previously, the unwind situation arises when the taxpayer is mistaken about the circumstances, *Y*, under which she undertakes *X* to achieve *Z*. The mistake means that *A*'s belief that *X* will function as a means to *Z* is false.

Cases previously discussed exemplify the generic fact pattern. For example, in *Sinopoulo v. Jones*,¹⁹⁵ the taxpayer obtained a judicial reformation of a trust instrument so that it would satisfy the newly enacted (and retroactively applicable) state law definition of an irrevocable trust. The parties had not been mistaken about the nature of the original trust instrument; they were mistaken about the consequences of having executed it. Thus, the relief sought was a genuine unwind. Consistent with the courts' general antipathy toward treating noncommercial reversals as unwinds, the reformation was given prospective effect only for tax purposes.¹⁹⁶ In the case of *nunc pro tunc* amendments of divorce decrees, the same antipathy is evident. Typically, the reason for the state court's amendment of a previously issued decree is that information about the parties has become available that undermines the court's original determinations of the appropriate amount of support and the proper division of marital assets. The reformation does not purport to state what was initially in the decree but only to make the decree serve the purpose it had always been intended to serve.¹⁹⁷ Thus, again, the problem is a failure of the instrument under the circumstances, not an error about what the instrument was or did, and the courts typically have declined to accord retroactive effect to the amendment.¹⁹⁸

Moreover, the government's antipathy toward unwind relief extends to the business context as well, as the case of a revocation of an election under § 83(b) illustrates. Under the general rule of § 83(a), a service provider who is paid with property that is subject to a restriction on subsequent transfer or to a risk of forfeiture (both such limitations, "restrictions") does not recognize income until the restriction is lifted. Section 83(b) provides an override to the general rule, permitting the service provider to elect to treat the property as

¹⁹⁵ 154 F.2d 648 (10th Cir. 1946).

¹⁹⁶ *Id.* at 649–51. A similar case is *Van Den Wymelenberg v. United States*, 397 F.2d 443 (7th Cir. 1968), in which a failure of the trust drafter to follow instructions of the settlor led to a reformation when the error was discovered. Retroactive effect to the reformation was denied. Again, there was no dispute about what occurred—only a dispute about whether it should be treated as having taken place, given its failure to achieve the taxpayer's purposes. *Id.* at 444–46.

¹⁹⁷ *Gordon v. Comm'r*, 70 T.C. 525, 530–31 (1978).

¹⁹⁸ See *supra* text accompanying notes 76–77.

received free and clear, and therefore as taxable, on the date of receipt at its then-fair market value, even though it is restricted. Any subsequent gain or loss realized in the value of the property is then treated separately from the initial receipt, generally as a capital transaction.¹⁹⁹

Section 83(b) and the regulations thereunder also permit a revocation of the election in certain circumstances.²⁰⁰ Among other requirements, the revocation may be made only when the taxpayer makes the election “under a mistake of fact as to the underlying transaction” and the mistake is not “as to the value, or the decline in value, of the property.”²⁰¹ In a series of private letter rulings and a recent revenue procedure,²⁰² the IRS has ruled that no revocation will be allowed unless the mistake goes to the substance of the transaction; a mistake about the surrounding factual circumstances²⁰³ or about the legal consequences of the election²⁰⁴ will not qualify. In no reported ruling has the IRS granted the election on the basis of a claim of mistake of fact.²⁰⁵ In other words, the IRS has adopted a general rule of no unwinding of the election.

C. Observations

Situating unwinding on the spectrum of available remedies for tax errors offers some insight into what a more coherent unwinding doctrine would look like, as well as into some of the incoherence of current law. The unifying

¹⁹⁹ See Treas. Reg. § 1.83-2(a) (2007). The risk the taxpayer runs in electing under § 83(b) is that the property will be forfeited. In that case, the taxpayer is entitled to no deduction to offset the prior inclusion. At most, she has a (typically) capital loss equal to the amount of consideration actually paid (if any) for the property over the amount realized (if any) on forfeiture. *Id.*

²⁰⁰ Treas. Reg. § 1.83-2(f) (2007).

²⁰¹ *Id.*

²⁰² Rev. Proc. 2006-31, 2006-27 IRB 13.

²⁰³ See, e.g., I.R.S. Priv. Ltr. Rul. 85-11-065 (Dec. 18, 1984) (factual mistake concerning options to which the election applied); I.R.S. Priv. Ltr. Rul. 83-33-091 (May 19, 1983) (mistake as to option terms).

²⁰⁴ See, e.g., I.R.S. Priv. Ltr. Rul. 2002-12-021 (Mar. 22, 2002) (mistake of law); I.R.S. Priv. Ltr. Rul. 85-26-074 (Apr. 4, 1985) (same).

²⁰⁵ As of this writing, the IRS has issued nine letter rulings interpreting the revocation provision of Reg. § 1.83-2(f). In these rulings the IRS has granted revocations based on mistake of circumstances only where the revocation occurs before the expiration of the period to make the initial election, see, e.g., I.R.S. Priv. Ltr. Rul. 2002-29-004 (July 19, 2002), but these rulings are based on the independent policy ground that making the election early should not put the taxpayer in a worse position than one who waits until the end of the election period, see *id.* (citing authorities). The one (hypothetical) situation that the IRS has identified as an appropriate case for relief on the basis of mistake involves a mistake concerning the nature of the property to which the election is made. Where a service provider is promised restricted Class A stock, receives restricted Class B stock instead, and is unaware of the existence of Class B stock at the time of receipt, a revocation of the § 83(b) election will be permitted based on mistake of fact. Rev. Proc. 2006-31, 2006-27, I.R.B. 32. This case, of course, is much closer to claim of right than to an unwind.

thread of relief in all of the tax errors discussed is the idea of excusable mistake of one kind or another. For example, inconsistency in reporting generally will preclude a taxpayer from benefiting from a current position even if it is correct.²⁰⁶ Not surprisingly, given the fact that inconsistency is avoidable without regard to the actual facts, equitable recoupment is available only when the other party does something that creates the inconsistency. Similarly, in the factual error case (where the reported transaction differs from the actual transaction), no relief is available if the taxpayer had no basis for failing to characterize the transaction properly at the outset.²⁰⁷ However, because a reasonable failure to know the facts is a relatively common occurrence, the situations in which relief may be available arise more frequently than in the equitable recoupment case.

Likewise, it is possible to make out a case for excusable failure to understand the circumstances of one's actions—and therefore for unwinding—and to distinguish such cases from others in which, for example, the taxpayer simply does not bother to investigate the facts or to consider the consequences of her action. As an example, the reversal of a dividend that was issued based on a scrivener's error about the corporation's balance sheet might be thought to be a basis for unwinding treatment, whereas a reversal following upon the re-evaluation of the wisdom of paying the dividend might not.²⁰⁸ Similarly, the occurrence of an "act of God" triggering a right of reversal for a contracting party might suggest unwind treatment if the reversal occurs, whereas the exercise of such an option based upon a mere reconsideration of the desirability of entering into the transaction would suggest that unwind treatment not apply. In short, if the tax law adopted the same approach to

²⁰⁶ See, e.g., *Cont'l Oil Co. v. Jones*, 177 F.2d 508 (10th Cir. 1949). *Continental Oil* illustrates a typical fact pattern. The taxpayer valued stock at \$1 per share on receipt and included this amount in gross income. See *id.* at 510. In a later year, the stock was sold and the taxpayer sought to use its correct value, \$244 per share, as the basis for computing gain or loss. *Id.* The court required the taxpayer to use the \$1 value, even though the \$244 figure was correct. *Id.* at 512. At the time of the audit of the later year, the year in which the initial valuation had been made was closed. *Id.* at 509–10. There was no indication that the taxpayer's initial valuation was fraudulent. The court stated that the taxpayer was not permitted to "shift his position to his advantage." *Id.* at 512.

²⁰⁷ See I.R.C. § 6651(a)(3) (2006).

²⁰⁸ As a general matter, the compulsory return in a later year of a lawfully issued dividend will result in an initial inclusion, followed by a deduction. See *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932). In some cases, the hardship of this rule has led the court to conclude that the initial distribution was impressed with a constructive trust that precluded treatment of the distribution as income. See, e.g., *Knight Newspapers, Inc. v. Comm'r*, 143 F.2d 1007, 1011 (6th Cir. 1944). A voluntary return, however, generally will not be accorded true unwind relief nor afford the taxpayer a deduction. See I.R.S. Field Serv. Adv. 2001-24-008 (June 15, 2001) (reviewing authorities).

contextual error that it does to the reporting of asserted facts (TBR and claim of right) and to their assertion (equitable recoupment), a comparatively expansive income tax unwinding doctrine would result in that the same-year requirement would be removed.

As previously discussed, neither the IRS nor the courts have taken this approach—at least where the error is discovered or materializes in a subsequent year.²⁰⁹ One possible basis for the narrower scope of relief for reversals may be the fact that most contextual reversals are voluntary. As contrasted with the other types of excusable error, the reversal will not follow automatically on the discovery of the error. Hence, one finds most putative unwinds in the business context, in which the reversal generally follows in a mistake-of-fact type of situation such as that discussed in the TBR and claim of right cases.²¹⁰ In the donative transfer situation, such as that of a mistaken gift or a trust that takes inadequate account of the surrounding circumstances, unwinding is rarely accorded under the income tax.²¹¹

In short, and apart from administrative considerations that might qualify the conclusion, it appears that the tax law is largely incoherent on the treatment of factual errors and unwinding generally. If the compulsory nature of a reversal is considered one of the necessary conditions of unwind treatment, then Revenue Ruling 80-58 is overbroad in permitting unwinds in the same taxable year as the original transaction, regardless of whether the reversal is a product of the taxpayer's choice.²¹² On the other hand, if the sanctity of the annual accounting principle provides the basis for according or denying unwinding relief, it is unclear why the principle does not also govern claim of right and TBR cases, at least where the error giving rise to the later-year adjustment concerns the taxpayer's knowledge of underlying facts that themselves have not changed.²¹³

Hence, given the close similarity between unwinding and claim of right and TBR scenarios, it would be possible to bring greater coherence to the tax law simply by moving in either direction more consistently for both types of cases. For example, unwind relief could be made available only if the reversal were

²⁰⁹ See *supra* Part I.B for a discussion of the relevant authorities.

²¹⁰ See *supra* Part I.B.2.

²¹¹ See *supra* Part I.B.2, I.B.3.

²¹² Even though Revenue Ruling 80-58 seems to assume that the reversal is automatic if the zoning variance is not given, the ruling does not predicate the unwind on involuntariness.

²¹³ For example, it is not clear why a deduction should be available in the later year on the taxpayer's discovery that she never received an item that she included in a prior year.

involuntary, but without any greater regard for the annual accounting principle than claim of right or the TBR require. In that case, true unwinding, where the reversal is elective, would never occur, but quasi-unwinding would be available both during and after the current tax year, assuming the reversal were involuntary and any other requirements were satisfied. Relief might differ in the two cases in minor ways, such as by simply disregarding both transactions (as under current law) if they occurred in the same year, while furnishing the taxpayer only a deduction or requiring only an inclusion, without interest, in the case of later-year reversals.²¹⁴

In the alternative, respect for the annual accounting principle could be treated as controlling for purposes of according unwind relief, in which case the same approach should extend, it would seem, to the claim of right and TBR cases, which is to say that the latter doctrines effectively would be abolished.²¹⁵ Instead, subsequent exclusions or inclusions would be evaluated on their own terms, rather than in relation to a prior inconsistent event, and inconsistent events not resulting in an inclusion or a deduction would have no tax consequence.²¹⁶ Same-year voluntary reversals, however, would be accorded unwind relief.

Likely a better approach than either of these would be one that hewed more closely to the concept of an excusable error, for which, in the final analysis, involuntariness would seem to serve as a proxy anyway. Indeed, the concern with involuntariness would seem to place undue focus on the second transaction, when the reasonableness of an error depends primarily on the conditions under which the parties acted at the outset. Moreover, excusable error, and not involuntariness, also underlies both equitable recoupment and claim of right and TBR cases. Hence, a focus on excusable error also offers the prospect of reshaping unwinding doctrine to make it generally consistent

²¹⁴ For example, if a later-year rescission were accorded unwind treatment, the seller would take her original basis in the property and a deduction equal to the amount of gain recognized on the sale. No refund for accrued interest on the excess tax paid between the initial year and the unwind year would be made. Where the initial transaction generated a loss, there would be a later-year inclusion, again with no interest payable to the government.

²¹⁵ At least one commentator has argued that the TBR is an unnecessary feature of the income tax because existing mechanisms, such as the adjusted basis rule of § 1016, suffice to ensure proper treatment of later-year inconsistencies. See Steven J. Willis, *The Tax Benefit Rule: A Different View and a Unified Theory of Error Correction*, 42 FLA. L. REV. 575, 604–05 (1990).

²¹⁶ This result would conflict with that in *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 423–25 (1983), in which the Court ruled that a closely held corporation that had previously deducted the full cost of cattle feed and later adopted plan of liquidation before all the feed was used in its business was required to include in income the amount of the unwarranted deduction, despite the absence of a “recovery.”

with the treatment of other types of error and dispenses with the largely artificial constraint of the annual accounting principle to the extent that the principle is thought to bar all relief in a later taxable year.

Against the involuntariness standard, consider that reversals under the claim of right doctrine (and, for that matter, under the TBR), though typically automatic, reflect prior arrangements voluntarily entered into, often on the basis of mistaken factual assumptions or even consciously unlawful acts.²¹⁷ Thus, even inexcusable ignorance in entering into the first transaction may entitle the taxpayer to a deduction in a later year as long as the repayment itself is not voluntary.²¹⁸ More to the point, it remains unclear why a voluntary reversal resulting from ignorance of facts that were not reasonably within the taxpayer's contemplation at the time of the first transaction should be denied unwind treatment. Such a rule amounts to a standard of strict liability for knowledge of the facts in the unwinding situation, apparently solely on the basis that the element of volition has a tighter nexus to the reversal than it does in the claim of right case. Perhaps the thought is that in the voluntary reversal setting the parties can allocate the tax costs between them, whereas tax allocation is not as likely to be available on an automatic reversal. That notion, however, seems ill-supported as a factual matter because the parties should be capable of anticipating a voluntary reversal prior to entering into the first transaction. In addition, tax costs are not readily allocable in donative transfer or other situations (such as tax elections) in which there is no counter-party. In short, it seems that the idea of voluntariness as a basis for denying unwind treatment is difficult to defend.

Of course, to reject involuntariness as a necessary condition of according unwind treatment is not to articulate an alternative standard. Involuntariness, however, does appear to serve as a proxy for the more general standard of whether the circumstance giving rise to the reversal is something that the taxpayer should have taken account of *ex ante*. The same inquiry also underlies claim of right and, implicitly, equitable recoupment (demarcating the

²¹⁷ See, e.g., *Memphis Mem'l Park v. McCann*, 133 F. Supp. 293, 299 (M.D. Tenn. 1955) (holding deductible under the claim of right doctrine deductions for make-up contributions to a trust in respect of payments required, but not made, in prior years); *Wetstone v. United States*, 5 A.F.T.R. 2d 1486 (D. Conn. 1960) (granting deduction to estate for return of excess salary payments to decedent, whose demands therefor were acceded to by other partners for the sake of family harmony).

²¹⁸ See, e.g., *Equitable Life Ins. Co. of Iowa v. United States*, 340 F.2d 9, 14 (8th Cir. 1965) (holding that payments of extra interest by taxpayers in connection with bond redemption did not qualify for deduction under claim of right because redemption was voluntary).

line between acceptable and unacceptable inconsistency, the latter of which the taxpayer generally is estopped from asserting²¹⁹). While necessarily a case-by-case judgment, the standard is workable in those instances and should also be applicable, at least in theory, in the voluntary unwind case. Analytically, the standard is equivalent to asking whether the choice to undertake *X* under conditions *Y* was a subjectively rational but an objectively irrational means to effect *Z*, bearing in mind that *Z* must be understood as the state of affairs *A* brings about by her own action and does not include the hoped-for consequences thereof.²²⁰

As an example, consider a decision by *A* to invest in IBM stock. *A* hopes the investment will be profitable, but there is no guarantee that it will. As we have seen, in formal terms one may say that *A* does *X*—invests in IBM stock—under conditions *Y*—the conditions that obtain when she makes the investment—in order to achieve end *Z*. It is important to be very clear about the characterization of *Z*. It cannot be defined as “making a profitable investment in IBM” or in any similar way, inasmuch as bringing about the profitability of the investment lies outside of *A*’s control. Rather, *Z* must be defined as the end state that *A* intends to bring about *by her action*.²²¹ At the most general level, *Z* can only be understood as the making of a profitable investment *ex ante*, which is to say that under conditions *Y* the expected value of the investment is positive and indeed sufficiently so to support that investment rather than another. That is what lies within *A*’s power, at least in the ordinary case; actual success does not, and, therefore, *X* cannot be construed as the means, or instrument, to that success. Similarly, the rationality of the decision does not depend upon the success of the investment any more than the winning of a lottery makes the person who guessed the correct numbers a rational actor for having done so.

The question of whether a decision to reverse such an investment should merit unwind treatment depends, in turn, upon on two separate questions. First, given what *A* reasonably knew and should have known when she invested in IBM stock, was the expected value of the investment sufficiently

²¹⁹ See *Cont’l Oil Co. v. Jones* 177 F.2d 508, 512 (10th Cir. 1949); see also *Orange Sec. Corp. v. Comm’r*, 131 F.2d 662, 663 (5th Cir. 1942) (“When . . . a fact or transaction [on which a taxpayer has taken a position] is projected in its tax consequences into another year there is a duty of consistency on both the taxpayer and the Commissioner with regard to it . . .”).

²²⁰ The following discussion draws heavily on Carl G. Hempel, *Rational Action*, in 35 *PROC. & ADDRESSES AM. PHIL. ASS’N* 5 (1962).

²²¹ See *id.* at 7.

positive?²²² That is, did *A* have rationally defensible reasons for investing in IBM stock as a means to create an ex ante positive investment of a particular sort? Second, given the facts as they later proved to be, was it not in fact rational to make an investment in IBM under *Y* in order to create such an ex ante positive investment? Here, the question is not whether the investment proved profitable (indeed it may have), but whether the end *A* intended to achieve by investing in IBM stock could rationally be expected to result from doing so under *Y* as *Y* actually was. If it could not, then unwinding would seem appropriate, at least without regard to possibly countervailing administrative or other concerns taken up below. Thus, suppose *A*'s investment had been based on inaccurate financial reporting from IBM that was the result of incompetent outside accountant practices. One might consider the decision to have been rational at the time of the investment but not in light of the actual facts, knowledge of which should have been, but was not, available at that time. Under these circumstances, there were not, in fact, good reasons to invest in IBM as a means to create a sufficiently profitable ex ante investment, and a reversal ought to give rise to unwind treatment.

By contrast, if there were no error in financial reporting and *A* simply conducted a poor investigation of the facts, her action was not rational in the first place, and there would seem to be no basis for unwinding a reversal. As above, there were not good reasons to invest in IBM, but unlike the preceding case, there also were not good subjective grounds to do so. Similarly, *A*'s analysis may have been complete and rational, but the investment may simply have not panned out. This outcome would reflect the fact that an ex ante positive investment may have negative value ex post, not that *A* did not in fact attain *Z* by doing *X* under *Y*. Again, there would be no basis for an unwind if the investment were reversed.

One should not suppose that this formal account of rational action provides a guide to the evaluation of any particular case, inasmuch as what counts as sufficient investigation on an ex ante rather than ex post basis depends upon individual circumstances. What, for example, counts as not a good reason for investing in IBM stock? Rather, the account developed here provides a method for classifying cases. For example, the determination that an actor has acted rationally but in ignorance of relevant facts, rather than either irrationally or rationally but with bad luck, cannot be answered with reference to a model of rational action. The determination depends upon what one considers to be

²²² See *id.*

the sort of information an actor can be expected to have ex ante, as well as what one considers to be sufficient investigation and analysis. These considerations depend, in turn, upon generally accepted norms of conduct. A classification of any particular case as rational but excusable, or as irrational or the product of bad luck, follows from the application of the norms; it does not guide them.

To illustrate: One can readily imagine a range of cases under which the same transaction and its reversal would give rise to different tax consequences, depending upon the circumstances.²²³ Returning to the case of *S*'s sale of *Blackacre* to *B*,²²⁴ one might expect, for example, that a sale rescinded on the basis of one party's misrepresentation to the other would be unwound as to the innocent party. At the other end of the spectrum, a reversal that resulted from one party's reconsideration of whether she wanted to do the transaction and the other party's willingness to accommodate her would seem to preclude unwinding treatment for either party. In between lie a range of closer cases: one party's mistake about her own circumstances that was based on misinformation provided to her (accountants' errors), mutual mistake about the circumstances of the exchange (the economy is not in fact booming), one party's mistake resulting from her own lack of diligence (seller is her own accountant), and so forth. Where these come out depends upon how the facts of the particular case affect one's judgment about whether the mistake concerning the circumstances is "reasonable," much as the question of whether a tax benefit claimed in a prior year or a prior inclusion based on a claim of right was reasonable. If a prior tax benefit was reasonably claimed and is later reversed, the TBR governs the inclusion; if it was not, then the taxpayer at least in theory is subject to interest and penalties for failure to report income accurately in the earlier year.²²⁵ Similarly, if a prior inclusion under a claim of

²²³ I thank Don Herzog for highlighting the conceptual difficulties discussed here.

²²⁴ See *supra* notes 1–2 and accompanying text.

²²⁵ See I.R.C. §§ 6601 (interest on late payments), 6651 (penalties for understatement of tax liability) (2006). Of course, the taxpayer generally must be audited before either interest or penalties will accrue, as there is no requirement to file an amended income tax return on later discovery of an error. See Treas. Reg. § 1.451-1(a) (2007) (establishing that taxpayer "should" correct erroneous inclusion or exclusion from gross income later discovered); Treas. Reg. § 1.461-1(a)(3) (2007) (establishing that taxpayer "should" correct erroneous deduction later discovered). *Badaracco v. Comm'r*, 464 U.S. 386, 397 (1984) (holding "should" command of regulations does not impose legal requirement to amend prior-year income tax returns). As an example of an unreasonably claimed benefit, consider a deduction claimed for expenses for items used in a hobby when the taxpayer had no income during the year from the hobby. The deduction would be disallowed under § 183. If in a later year it were discovered that the items were not used in a hobby but for some other personal purpose, it is not clear that any basis for an inclusion in the later year would exist.

right was reasonable and the inclusion is reversed, a deduction or credit will be available;²²⁶ if the prior inclusion was not reasonable, a present deduction on its reversal is less certain.²²⁷ Both in these cases and in the case of true unwinding, the determination of the reasonableness of the initial characterization is contextual and fact-dependent.

A virtue of a model of rational action such as the one offered here therefore is not that it provides a sound rule for deciding whether unwinding should apply to any particular reversal. Rather, the virtues are that it indicates which criteria should be applied in making that determination, and it provides a way to situate unwinding within the general framework of errors, each of which is susceptible to a similar classification based on a similar judgment. Thus, one can distinguish between excusable and inexcusable failures of logical consistency as well as between such failures with regard to the characterization of what one does. As the preceding discussion has shown, these kinds of judgments underlie the availability of relief for taxpayer errors of all kinds.

D. “Reasonable” Excuse Generally

One might grant that achieving parity between unwinding and other kinds of income tax errors would require the adoption of a reasonableness standard for unwinding, but question whether parity is a sufficient basis to do so.²²⁸ In other words, the mere fact that the error was in some appropriate sense reasonable might not justify relief, even though extending relief in that case would serve the value of consistency. As an alternative, it might be better, all things considered, to leave the costs of all tax errors where they lie or at least to leave all costs of errors caused by taxpayers where they lie on the ground that it is taxpayers, after all, who determine their courses of action. Consider that a similar regime operates in the case of a standard contract. Apart from generic “acts of God” clauses, contracting parties are strictly liable for the direct and incidental damages resulting from failure to perform their contractual obligations, absent an explicit contrary allocation of liability in the

²²⁶ I.R.C. § 1341 (2006).

²²⁷ As an example, consider a taxpayer who erroneously includes a bequest in income, only to discover in a later year that the bequest should have been paid to another beneficiary of the decedent. If the amount is paid over to that other beneficiary, the basis for a deduction to the first beneficiary is unclear at best because there was no reasonable basis to include the bequest in income in the first place. See I.R.C. § 102(a) (2006) (“Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.”).

²²⁸ It is important to keep in mind that the considerations addressed here relate to income taxes and other non-transactional taxes. For considerations relevant to how transactional taxes differ, see *supra* Part II.A.1.

parties' agreement.²²⁹ Why not extend the same rule to tax errors? In the case of reversals, taxpayers would be stuck, which is to say they would bear the tax cost themselves, except to the extent that they could negotiate for another party to assume the liability. Such a rule might seem particularly attractive once incentive effects are considered. A rule that puts the cost of errors on the acting parties presumably gives the proper incentives to make sure that errors happen less frequently than they would if the risk were borne by the government, which is to say spread in some way among the rest of the populace, who are not parties to the arrangement.²³⁰

This proposal has a surface plausibility that, I believe, is not borne out on closer consideration. In the context of a reasonableness inquiry, it is easy to be led astray by incentive effects analysis. The concept of reasonableness presumably incorporates already a view about what constitutes appropriate search costs. Action that is deemed reasonable, even though based on misinformation, would, then, have been undertaken only after appropriate search costs were invested. Therefore, at one level, the idea of giving an additional incentive to reduce errors is misguided. If, by definition, reasonableness presupposes incurring sufficient search costs, then providing an incentive to incur more is inefficient. To be sure, there is some play in the concept of reasonableness because what is taken as reasonable may depend in part on norms that do not implement a cost-benefit analysis.²³¹ Nonetheless, in the abstract, the incentive analysis would not seem to point toward shifting liability in one direction or another. Norms that depart from a cost-benefit calculus could have an effect at the margin either way.

The more important question on the incentive side is whether parties acting reasonably are properly internalizing costs.²³² A reasonableness standard yields the right level of precaution only if the parties who create the associated costs bear them, and not more.²³³ If there is a net externality in either direction, the cost-benefit analysis will be skewed: Parties acting rationally either will be asked to bear costs that exceed those their activity creates, or

²²⁹ See, e.g., Curtis Bridgeman, *Reconciling Strict Liability with Corrective Justice in Contract Law*, 75 *FORDHAM L. REV.* 3013, 3014 (2007) ("[C]ontract law has a strict liability standard of fault.").

²³⁰ This observation underlies much of the more recent literature on tax transition policy, an area closely related to unwinding. See DANIEL N. SHAVIRO, *WHEN RULES CHANGE*, ch. 2 (2000).

²³¹ What counts as reasonable depends not only on relatively objective factors such as the costs to various parties from one rule or another, but also in part on what people think as reasonable, which varies in different contexts and can change over time.

²³² HARVEY ROSEN, *PUBLIC FINANCE* 92-94 (7th ed. 2005).

²³³ *Id.*

they will not be required to bear their costs fully. The results are inefficiently low or high levels of reversals, respectively.

In the present case, and disregarding the incentive effects to unwind or not that depend upon the tax position of the parties,²³⁴ it is not at all clear that any substantial externalities are present, apart from administrative costs. On average, granting unwind treatment to a reversal is as likely to unwind a loss as it is a gain, apart from the real rate of growth, which over the long term seems to be in the neighborhood of three percent annually, after adjustment for inflation.²³⁵ Therefore, there may be a slight reduction in tax revenue under an unwind regime, assuming the reversal happens without regard to the tax treatment that applies to it. On the other hand, if unwinding is never available, then, at the margin, efficient transactions may not occur because of an unquantifiable tax risk should the parties wish to back out. Presumably, these factors—the loss of tax on the real rate of return on one hand and the discouragement of marginally efficient transactions on the other—are minor from a revenue perspective. It is hard to imagine that the dollars involved are significant and harder still to quantify them. Thus, the non-tax-based incentive argument against allowing unwinding seems weak.

On the equity side, the question is whether the fact of reasonableness in one's error means that it is not appropriate to say that one has "acted" at all for tax purposes, given the reversal. The question is equivalent to whether a strict liability regime, rather than a fault regime, ought to apply to the taxpayer for the tax consequences of her acts. In the case of strict liability without fault, there is no reason why the person should have acted differently even though an external "harm" results, yet we charge the person with the harm nonetheless. The usual justification is that doing so provides an efficient method of spreading the risk or costs of such harms.²³⁶ That is, it is not that we do not want the harm-causing conduct to occur. Rather, we want it to occur and we believe that a strict liability regime best accomplishes the goal of efficiently spreading the costs associated with it. A fault regime, by contrast, seeks to prevent certain conduct from occurring by forcing actors to internalize its

²³⁴ These issues are taken up in Part III, *infra*.

²³⁵ See Philippe Weil, *The Equity Premium Puzzle and the Risk-Free Rate Puzzle*, 24 J. MON. ECON. 401, 402 (1989). Note that loss limitations would reduce and could well eliminate even the average expected revenue loss from unwinding. See *supra* note 121.

²³⁶ See, e.g., Gregory C. Keating, *The Theory of Enterprise Liability and Common Law Strict Liability*, 54 VAND. L. REV. 1285, 1317–21 (2001) (explaining that strict liability is an efficient method of spreading the cost of harm because the actors are held accountable for any injuries caused by his or her actions).

expected costs.²³⁷ Such a regime prevents conduct from occurring if its ex ante cost exceeds the ex ante cost of not engaging in it.²³⁸

Hence, the question is whether there is anything to be gained from requiring taxpayers to bear the costs of conduct for which they are not at fault. In the tort setting, what is gained is an efficient allocation or distribution of costs that are taken as given.²³⁹ The difference in the tax setting is that the only costs, on average, are administrative.²⁴⁰ Therefore, the trade-off is between inefficient deterrence of taxpayer conduct by imposing costs where they cannot be foreseen and additional waste associated with administering an unwind regime. If, as stipulated previously, we initially disregard tax-based incentives for seeking unwind treatment, then administrative costs would not appear to be very great and it seems that a fault-based line for permitting or denying unwind treatment would be appropriate.

III. UNWINDING IN PRACTICE

As indicated in the Introduction, two considerations should motivate the analysis of putative unwind situations in the first instance: the type of tax involved and the administrative capacity of the government to deal with unwinds. The type of tax is critical because the availability of unwind treatment hinges in large measure on whether the reversal means that no taxable event has taken place. The capacity of the government to deal with unwinds goes to questions of administrability. In particular, it goes to whether the prospect of evasion or avoidance of tax is so likely that it outweighs considerations of substance that might otherwise justify granting unwind treatment.

The discussion thus far has shown that the authorities generally have been more liberal in according unwind treatment in the transactional tax context than in the income tax context, consistent with the different nature of the two types of taxes. Here, the focus shifts primarily to the income tax, where the considerations that support or oppose unwind treatment are inherently more

²³⁷ See Guido Calabresi, *Optimal Deterrence and Accidents*, 84 YALE L.J. 656, 657 (1975).

²³⁸ This is simply a statement of the "Hand rule." See *United States v. Carroll Towing*, 159 F.2d 169, 173 (2d Cir. 1947).

²³⁹ See, e.g., Gregory C. Keating, *The Idea of Fairness in the Law of Enterprise Liability*, 95 MICH. L. REV. 1266, 1330 (1997).

²⁴⁰ See *infra* Part III for a discussion of tax motivation. One could argue that the uncertainty in federal tax revenue that arises from opening prior years is a cost, but on an aggregate basis this cost must be near zero.

ambiguous. Part III.A addresses substantive issues and Part III.B addresses administrative concerns.

A. Substantive Issues

In Part I.A, it was argued that the generic unwind problem poses the question of whether a transaction that has been “reversed,” together with the reversing transaction, are to be disregarded for tax purposes. In that context, the term *reversal* was reserved for those transactions that follow upon the disclosure of an event or condition existing prior to the time the transaction becomes effective that (1) thwarts part or all of the purpose of the transaction; and (2) had it been known from the outset, would have prevented the transaction from occurring (in whole or part). In the absence of such an event or condition, no reversal can occur (even if there is a return to the pre-transaction status quo), and the unwind analysis need not proceed.

Two further substantive issues arise at the practical level. The general contours of an unwinding doctrine have been articulated, but two questions remain whether any further limits on unwind treatment should apply where the second transaction is a reversal. The first is whether a failure to understand the legal consequences of an action, rather than some sort of factual error, can support unwinding treatment. The second is whether tax motivation in either the original transaction or the reversal can do so.²⁴¹

1. Mistake of Law

Mistake of law presents a special case because granting relief for it may offend what is often taken as a general policy of ascribing knowledge of the law to legal actors.²⁴² From this perspective, ignorance of the applicable law is conclusively presumed to be an unreasonable mistake. Even apart from the possibilities for opportunistic ignorance of the law or for claims of such ignorance, it may be desirable to impute knowledge of the law to legal actors

²⁴¹ Tax-motivated reversals should be distinguished from reversals, which may or may not be tax-motivated, of tax-motivated transactions. Borrowing to finance the purchase of a tax-favored investment might be an example of the first. See I.R.C. § 265(a)(2) (2006) (denying deduction for interest on debt used to purchase or carry tax-exempt obligations). A reversal of the arrangement may or may not qualify as tax-motivated. The reversal of an employer’s loan to an employee, together with a return of stock financed with the loan, may represent a tax-motivated reversal of a non-tax-motivated transaction. The purpose would be to avoid cancellation of debt income on a simple loan cancellation. See *id.* § 61(a)(12) (including income from discharge of indebtedness in gross income).

²⁴² See, e.g., *Atkins v. Parker*, 472 U.S. 115, 130 (1985).

in order to encourage beneficial pre-action investigation. Unlike facts, which may not be knowable beforehand, in theory the law is ascertainable before individuals act.²⁴³ If they are presumed to know the law, they will have an incentive actually to know it, but if mistake of law is an excuse for unwinding, then there will be much more mistake of law and many more unnecessary reversals.²⁴⁴

Whatever the merits of the “deemed to know” rule for mistake of law, in the tax context the analysis is somewhat more complicated because the underlying substantive law, as contrasted with the tax law itself, may play a role analogous to that of facts in the more standard mistake case.²⁴⁵ Consider, for example, a failed corporate reorganization that results in a transaction taxable to the target corporation and its shareholders.²⁴⁶ One can imagine two distinct sorts of legal error leading to this outcome: failure to understand and satisfy the legal requirements for qualifying the transaction as a reorganization, and failure to understand the state law consequences of actions taken by the parties, on which the tax consequences, in turn, depend. In the former case, the state of affairs following the first transaction is as the parties expected, but its tax attributes are different. In the latter case, the state of affairs to which the tax law applies differs from what the parties expected because the relevant “facts” depend upon state law that was not correctly understood.

One might question the relevance of this distinction on policy grounds, as the type of legal error does not seem to bear on whether the law should adopt a

²⁴³ Such a policy would seem to underlie the refusal to permit revocation of an election under § 83(b) only where “the transferee is under a mistake of fact as to the underlying transaction.” Treas. Reg. § 1.83-2(f) (2007).

²⁴⁴ The imputation of knowledge of the law, though often reasonable, is based on a simplified and idealized conception of law. In practice it may be unreasonable to expect individuals to know the applicable law beforehand, as when the law is unclear at the time legal actors act or when the law changes, with retroactive effect, after they act. See Kyle D. Logue, *Optimal Tax Compliance and Penalties when the Law is Uncertain* (Univ. Mich. Law & Econ., Olin Working Paper No. 06-009, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=950379. Notably, a large literature advocates no relief for legal actors even in the latter case, largely on the grounds that when actors know they will absorb the costs of legal change they will do so efficiently, either through rational anticipation or through private insurance. See generally SHAVIRO, *supra* note 230. To the extent the argument persuades in the legal transition context, it would seem to do so *a fortiori* when the law has not changed.

²⁴⁵ Thus, it is commonly said that while federal tax law is not subject to state law interpretations (such as of what constitutes “ordinary and necessary”), state law determines the property relations to which the tax law applies. See *Morgan v. Comm’r*, 309 U.S. 78, 80 (1940) (“State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.”).

²⁴⁶ See I.R.C. § 368(a) (2006) (exclusively defining the term “reorganization” for purposes of the federal income tax).

general policy of imputing knowledge of the law to actors. What difference does it make whether the mistake concerns the law that determines the treatment of the facts (i.e., the tax law) or the law that establishes the facts to which the former law applies? In fact, the difference can be material for a number of reasons. First of all, it is not clear that an incentive to know underlying state law serves a compelling enough federal tax policy objective to override the considerations that may otherwise support relief.²⁴⁷ Recall that in many cases, even an unreasonable mistake of fact will merit relief when the mistake is discovered. Given the “fact establishing” role that state law can play, the distinction between mistake of underlying law and mistake of fact seems difficult to defend.

Secondly, mistake of local law does not raise the same tax policy concerns that a mistake of federal tax law raises. A mistake that concerns the federal tax consequences of the initial transfer raises the prospect of tax electivity if unwinding relief is offered. Permitting taxpayers to unwind in this circumstance would allow them to contest the initial denial of favorable treatment by the government and, if unsuccessful, to obtain a second-best result through the unwind.²⁴⁸ In effect, the availability of unwind treatment makes the tax liability on an alternate, less aggressive transaction the exercise price of a put option on taking a more aggressive position. The option itself is virtually costless. Given the low probabilities of audit,²⁴⁹ even a taxpayer committed to compliance with the applicable reporting standards obtains an option to play the audit lottery.²⁵⁰

Finally, considerations of comity may require treating local law like facts where state law so treats it even if the better federal tax policy is to attribute

²⁴⁷ See *Comm'r v. Bosch*, 387 U.S. 456, 465 (1967) (holding that federal authorities are not bound by the determinations of a state trial court when the federal estate tax liability turns upon “the character of a property interest” held and transferred by a decedent under state law).

²⁴⁸ There are many cases in which the taxpayer relied on incorrect tax advice in making transfers in trust. See, e.g., *Board v. Comm'r*, 14 T.C. 322, 323 (1950). When the mistake came to light the taxpayer amended the original transfers and sought unwind treatment on the basis that the intent at the time of the initial transfers was to minimize federal tax liability. *Id.* The Tax Court refused to treat the reversal as an unwind. *Id.* at 325.

²⁴⁹ In recent years, individual audit rates have hovered around 1%. See I.R.S., SOI Tax Stats-IRS Data Book: 2006, tbl. 9, <http://www.irs.gov/taxstats/article/0,,id=168593,00.html> (click on “table 9”) (last visited Jan. 14, 2008).

²⁵⁰ Generally, taxpayers must have “substantial authority” to take a position on a tax return without flagging the position for the government and avoid the penalty for a substantial understatement of tax if the position is determined to be incorrect. I.R.C. § 6662(d) (2006); Treas. Reg. § 1.6662-4(d) (2007). Substantial authority, however, is satisfied even if the probability of success on the merits (if litigated) falls somewhat below 50%. *Id.*

legal knowledge to actors. In general, federal tax authorities apply state law by giving “proper regard” to state lower-court adjudications and full deference to decisions of the state’s highest court.²⁵¹ Where state law itself provides relief for mistake of state law, federal tax law generally (though not always) will follow state law.²⁵² Thus, if state law provides for rescission of a transaction on the basis of a mistake of law, the tax authority generally will follow the state court rule,²⁵³ although, as discussed previously, any retroactive consequences of the state law are apt to be disregarded if the reversal purports to unwind the income tax.²⁵⁴

2. Tax Motivation

Courts have tended to look askance at bids for unwinding treatment of tax-motivated transactions that are later reversed when the transaction fails to provide anticipated tax benefits.²⁵⁵ In my judgment, this general antipathy toward tax motivation is misplaced. Setting aside the problems of detection and whipsaw (discussed below), it is unclear why the availability of unwind treatment for tax-motivated reversals should not turn on the same considerations that govern the tax treatment of tax-motivated behavior more generally. These considerations are primarily those of economic substance.²⁵⁶ The reversal of a tax-motivated transaction that itself satisfied the various

²⁵¹ See *Bosch*, 387 U.S. 456 (holding that federal authorities are not bound by the determinations of a state trial court when the federal estate tax liability turns upon “the character of a property interest” held and transferred by a decedent under state law).

²⁵² The “proper regard” standard of *Bosch* has been the subject of extensive academic commentary, some of which is discussed below. See, e.g., Paul L. Caron, *Bosch and the Allure of Adversariness*, 64 TAX NOTES 673–74 (1994); Paul L. Caron, *The Role of State Court Decisions in Federal Tax Litigation: Bosch, Erie, and Beyond*, 71 OR. L. REV. 781, 783–84 (1992); Bernard Wolfman, *Bosch Revisited*, 64 TAX NOTES 269 (1994); Bernard Wolfman, *Bosch, Its Implications and Aftermath: The Effect of State Court Adjudications on Federal Tax Adjudication*, 3 U. MIAMI INST. ON EST. PLAN. 2-1, 2-17 to 2-18 (1969).

²⁵³ See, e.g., *Neal v. United States*, 83 A.F.T.R.2d 99-2325 (3d Cir. Apr. 12, 1999) (holding that where under Pennsylvania law the power to rescind a gift arose from a mistake of law, and the power meant the gift was not complete, the taxpayer was entitled to a refund of gift taxes paid on prior release of contingent reversions when she rescinded the release.); I.R.S. Priv. Ltr. Rul. 2003-18-064 (May 2, 2003) (accepting as binding on federal government for tax purposes state law providing for retroactive reformation on agreement of interested parties).

²⁵⁴ See *supra* Part I.B.2.

²⁵⁵ See, e.g., *M.T. Straight’s Trust v. Comm’r*, 245 F.2d 327, 329–30 (8th Cir. 1957) (holding the federal tax authority not bound by state-court trust reformation that was intended to reduce federal income taxes); *Estate of La Meres v. Comm’r*, 98 T.C. 294, 308 (1992) (denying estate tax deduction on putatively retroactive modification of trust, where no non-tax reason for modification was apparent).

²⁵⁶ See BITTKER & LOKKEN, *supra* note 34, ¶ 4.3.

economic substance tests commonly applied in the tax law²⁵⁷ should not be denied unwind treatment simply because it is tax-motivated, for the simple reason that it, like the original transaction, has economic substance.²⁵⁸ If tax planning that involves arrangements sufficiently “real” in an economic sense is permissible, then tax “un-planning” of those arrangements may be too.²⁵⁹ All of this presupposes, of course, that the second transaction is a genuine reversal.

As an example, consider a tax-motivated sale-leaseback (itself a transaction that resembles a reversal) that is unwound because of factual mistake. In the initial transaction, *Seller-Lessee* sells *Hotel* to *Purchaser-Lessor*, and *Purchaser-Lessor* leases *Hotel* back to *Seller-Lessee*. The transaction is designed to provide tax benefits to *Purchaser-Lessor* in the form of depreciation deductions that have less value to *Seller-Lessee* than to *Purchaser-Lessor* (perhaps, for example, because *Seller-Lessee* is a tax-indifferent person).²⁶⁰ The parties, mindful of the authorities holding that sale-leasebacks involving a putative sale of the entire interest in the property followed by a leaseback for the expected useful life of the property lack economic substance,²⁶¹ make sure to assign enough economic benefit and risk to *Purchaser-Lessor* so that the transaction is sufficiently likely to be treated as a sale if audited. Toward this end, the parties may make the lease term significantly shorter than the expected useful life of the property, or they may require *Purchaser-Lessor* to bear certain customary costs of ownership, such as maintenance and taxes. The object of such measures is to ensure that *Purchaser-Lessor* is treated as the tax owner of *Hotel* during the term of the lease.

Shortly after the sale-leaseback, *Purchaser-Lessor* discovers that it will be unable to use the deductions afforded by the transaction because it was incorrectly advised by its accountants that it would have substantial net income

²⁵⁷ These include the doctrine of taxing substance over form, or taxing a transaction based on its real economic effects; the step transaction doctrine, or disregarding steps in a transaction that are present solely for tax purposes; and the economic substance test proper, which requires a real non-tax purpose to be a significant factor in the taxpayer's decision to engage in the transaction. See *id.* ¶¶ 4.3.3, 4.3.5.

²⁵⁸ The classic statement of the principle is Learned Hand's: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which best pay the Treasury." *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

²⁵⁹ It is important to bear in mind that the question here is not whether tax-motivated transactions should be eligible for unwind treatment, but whether the fact of tax motivation means that an unwind analysis is inapt or, put differently, whether tax motivation makes the circumstances of the two transactions different from those of the generic unwind: a transaction that fails to achieve its purpose, followed by its reversal.

²⁶⁰ See I.R.C. § 168 (2006).

²⁶¹ See, e.g., *Estate of Franklin v. Comm'r*, 544 F.2d 1045, 1047–49 (9th Cir. 1976).

during the expected useful life of *Hotel*. Pursuant to a clause in the parties' agreement, at *Purchaser-Lessor's* option they rescind the entire transaction. The sale and lease are cancelled, and any money that changed hands is returned. The question is whether the reversal in this circumstance is any different from the reversal in Revenue Ruling 80-58, the rescission ruling. If, as has been stipulated, the overall transaction, before it is reversed, is to be respected for federal income tax purposes, it is not clear why that result should not extend to treat the reversal as an unwind.²⁶² In particular, it would seem that the considerations involved in determining whether unwind treatment should apply are precisely parallel to those in determining that the initial transaction should be respected for income tax purposes. If the original transaction had economic substance, then it would seem that its reversal does too.

By contrast, some putative reversals that are tax-motivated lack economic substance and, therefore, should not be accounted true reversals in the first place. In such a case, the question of unwinding treatment does not even arise. As an example, consider an effort to unwind an employee's debt-financed purchase of company stock—a frequently recurring fact pattern in recent years.²⁶³ In a typical fact pattern, *Employer* would decide to compensate *Employee* in part through the grant of "nonstatutory" stock options.²⁶⁴ Sometime after the grant, when the price of *Employer* stock had risen substantially, *Employee* would borrow funds from *Employer* to finance the purchase of stock on exercise of the options, providing her note in return. The debt would be secured by the stock, but *Employee* would remain personally liable on the note. Later, when the stock declined nearly to zero in value, the arrangement turned out to be adverse to *Employee*, who had a large debt outstanding and no asset to show for it. In the absence of tax considerations, *Employer* would simply cancel *Employee's* note as a way to provide relief to *Employee*. The problem is that the cancellation would be unfavorable from a tax perspective because it would cause *Employee* to recognize compensation

²⁶² It is important to bear in mind that in the present discussion a mistake of fact is at issue; were the mistake of federal tax law, the considerations raised in the prior subsection would come into play.

²⁶³ See I.R.S. Rev. Rul. 2004-37, 2004-1 C.B. 583; I.R.S. Rev. Rul. 2004-11, 2004-1 C.B. 480 (holding that the employer's reduction of principal due on an employee's note payable to the employer the proceeds of which the employee used to finance exercise of stock options was compensation income to the employee).

²⁶⁴ "Nonstatutory" stock options are options not subject to the special rules of § 421 but to the rules of § 83 for property compensation paid to service providers. See 3 BITTKER & LOKKEN, *supra* note 34, ¶¶ 113.10, 60.5.

income equal to the amount of principal canceled.²⁶⁵ In order to avoid the result, *Employee* and *Employer* might reverse both the option exercise and the loan in effort to receive unwind treatment. Under this scenario, *Employee* returns the stock in exchange for the note and the options previously exercised, and *Employer* returns any principal amounts paid under the loan.

As contrasted with the sale-leaseback transaction, it is unlikely the transaction would be treated as an unwind, for the same reasons that any similarly tax-motivated transaction would be unlikely to be respected for tax purposes. The exchanges, taken in isolation, constitute a non-economic transaction for *Employer*: Instead of receiving the full value of the loan (plus interest), it receives its own stock back, worth substantially less. The effect of the exchanges, and the reason *Employer* agrees to them, is to compensate *Employee* for the unexpected drop in *Employer's* stock price. In effect, *Employer* has guaranteed *Employee* that she would not lose money on the equity compensation; that is, *Employer* granted *Employee* a put option on the stock. Hence, the exchanges do not constitute a reversal. Although, under the § 83 rules, the grant of that option, even if explicit, likely would not have triggered income to *Employee*,²⁶⁶ *Employee* would recognize income if and when the option was exercised in an amount equal to the difference between the size of the outstanding loan obligation and the fair market value of the stock.²⁶⁷ In other words, according unwind treatment is inconsistent with the economic substance of the buy-back because the second transaction is a reversal in form only. The overall effect is to be contrasted with that in the sale-leaseback transaction and that in Revenue Ruling 80-58, where the option value would have been built into the sale price of the property (increasing it), assuming the parties were dealing at arm's length.²⁶⁸ In that case, on average, the expected income consequences of such arrangements would be nil. In the long run, because they would be the same as the sale *sans* option case, the sale of the put option in the sale-leaseback in 80-58 raises the overall sale price in an amount that, on average, offsets the cases in which no income is treated as realized because of the unwind. In the employee stock case, by contrast, treatment of the return of the stock and cancellation of the loan as a reversal

²⁶⁵ I.R.S. Rev. Rul. 2004-37, 2004-1 C.B. 583; see Craig W. Friedrich, *Revenue Ruling Challenges Executive Stock Transaction*, J. CORP. TAX'N, May/June 2004, at 46 (noting that Revenue Ruling 2004-37 originated in an effort to "shut down abusive, to the fisc at least, transactions").

²⁶⁶ In general, the grant of employee stock options is a non-taxable event because most such options are deemed not to have an ascertainable fair market value at the time of grant. Treas. Reg. § 1.83-7 (2007).

²⁶⁷ I.R.C. § 83(a) (2006); Treas. Reg. § 1.83-7(a), (b)(3) (2007).

²⁶⁸ I.R.S. Rev. Rul. 80-58, 1980-3 C.B. 181-182.

(much less as an unwind), rather than as the exercise of an implicit option, will even on average fail to tax real economic income to the employee.

B. Tax Administration and the Problem of Government "Whipsaw"

As suggested in the Introduction, the peculiar nature of the income tax as a tax triggered by, but not "on," transactions, and as a tax that can be both positive and negative in amount, has significant ramifications for unwinding. These ramifications call into question the viability of unwinding as a generally available remedy under the income tax, apart from certain situations in which opportunities for abuse are limited or in which special considerations lie in favor of permitting unwind treatment.

Suppose one has concluded that, all things considered, permitting unwind treatment for income tax reversals makes sense on substantive grounds, as long as the mistake giving rise to the reversal is reasonable. As argued in Part II, such a conclusion might be justified in light of the factors that weigh in favor of having a realization rule at all, or in light of considerations of consistency or horizontal equity. In that event, one then might have special rules for obviously tax-motivated reversals and for mistakes of law, depending upon one's views about whether taxpayers ought to be charged with knowledge of the law. Even so, a generalized problem for a regime permitting income tax unwind treatment remains. It arises from the largely passive nature of the government's role in administering the tax system. Taxpayers report their income to the government; the government does not, in general, determine taxpayers' tax liability on its own, nor does it check most taxpayers' reporting of their incomes.²⁶⁹ The problem is familiarly known as whipsaw, or "heads, I win; tails you lose." There are two sources of the whipsaw: undetectable tax evasion and permitted tax avoidance.

Consider the example of *S*'s sale to and subsequent repurchase from *B* of *Blackacre*, discussed in the Introduction. Let us assume that the initial transaction is not tax-motivated and that the transaction is reversed because *Buyer* was legitimately unaware of a material background condition, in effect at the time of purchase, that made her purchase of *Blackacre* pointless. One can imagine two basic cases—where *Blackacre* is appreciated property and where it is depreciated. If it is appreciated, *Buyer* has an incentive to reverse the sale in line with the guidelines under the rescission ruling, Revenue Ruling

²⁶⁹ See *supra* text accompanying note 130.

80-58, assuming that either the transaction occurs in the same taxable year as the sale or the unwinding regime is of the sort that permits departures from the annual accounting rule along the lines of other transactional remedies, such as claim of right and equitable recoupment. If the requirements are satisfied, *Buyer* will be permitted to avoid recognition of gain on the original sale. Instead, she will take her earlier basis and tack her holding period.

If the property is depreciated, *Buyer* may elect simply to reverse the transaction and report it as an unrelated sale, thereby evading denial of the loss. Although this reporting would not be permitted, as a practical matter it may be very difficult for the government to monitor *Buyer's* conduct and detect the reversal. The effect is the whipsaw described above: When the taxpayer is in a gain position, the reversal is made known and tax is deferred; when the taxpayer is in a loss position, the reversal goes undetected and the loss is taken, even though in both instances the final result is the same.

If *Buyer* wishes to comply with the law, she still can achieve electivity in tax treatment if she is willing to bear some economic cost. Instead of engaging in evasion, she may simply avoid unwind treatment by negotiating with *Seller* for a transaction that is a close substitute for a reversal, but which falls on the other side of the reversal-separate transaction line.²⁷⁰ For example, it is relatively easy for *Buyer* to run afoul of the status quo ante requirement of Revenue Ruling 80-58. Similarly, if a time limit, such as the annual accounting rule, operates to bar unwinding past the close of the relevant period, the parties can simply wait to reconvey the property. Thus, at a minor economic cost, *Buyer* again achieves electivity in tax, and indeed perfectly legally. Nor is the problem solved by relaxing the requirements for what qualifies as a reversal. If the rule remains formal, then many transactions that are not reversals will enjoy unwind treatment, and electivity will still be a problem at the margin. If, instead, the rule is made into something like a standard—perhaps, for example, providing for unwind treatment in the case of reversals “in substance”—then opportunities for exploiting the reversal-separate transaction line will be diminished, but at the cost of inefficient uncertainty for taxpayers and the government. Even so, the reversal-separate transaction line would not be eliminated. In short, no solution is entirely satisfactory.

²⁷⁰ See Weisbach, *Line Drawing*, *supra* note 9, at 1627.

Finally, note that these difficulties do not afflict a transactional tax. Not only are the substantive grounds for granting unwind treatment to reversals stronger for such taxes, but also the problem of government whipsaw is essentially absent because taxable events rarely, if ever, are taxpayer-favorable.²⁷¹ Thus, taxpayers can be expected always to seek reversal of a failed transaction and unwind treatment of the reversal, with the consequence that electivity in tax treatment is eliminated.

These considerations do not imply that unwinding should be unavailable under an income tax. They only indicate that the case for income tax unwinding is weaker than the case for transactional taxes. The possibility of evasion or avoidance may be a cost worth bearing, especially if the contexts in which unwinding is deemed a permissible remedy are sufficiently salient to the tax authority that the worry about evasion is minimal, the options for avoidance are minimized, or both. For example, if seeking unwind treatment requires amendment of a prior year's return, the government's chances of detection are high. Similarly, where no close substitute for a given transaction is available, it may not be possible to avoid unwind treatment. Tax elections often have this property; so do marital annulments. In short, whether and to what extent unwinding should be permitted in the income tax context may depend upon judgments about costs and benefits that are inherently subjective. It is important, however, to have an understanding of what those costs are.

In light of these considerations, it appears unwinding should be available as a general matter for reversals in the transactional tax case, but more circumscribed in the income tax case. The *Appendix* depicts a decision tree based on the analysis developed here.

CONCLUSION

Unwinding, as a response to a generic type of error, should be viewed as an appropriate form of relief as long as it is possible to administer an unwinding regime effectively. The doctrine is inherently more at home in a transactional tax setting than under the income tax, both because unwinding as a form of relief is fundamentally about undoing transactions and because a genuinely transactional tax will rarely create the whipsaw potential that a non-

²⁷¹ An exception might be a value-added tax, which arguably is transactional in nature, but which presumably could be negative in the case of goods sold at a loss. If so, then the problem of whipsaw would arise here as well.

transactional tax can. Even in the transactional setting, however, one might conclude that certain kinds of reversals otherwise eligible for unwinding treatment should not be unwound because of adverse incentive effects.²⁷²

By contrast, unwinding represents a more problematic form of relief under an income tax. The tax itself is only contingently transactional, and the tax may be positive or negative. Consequently, the substantive case for unwinding treatment is comparatively weak, and the administrative case still more so. Apart from limited circumstances in which concerns of tax motivation or abuse are small or the non-tax stakes are very high (such as, for example, marital annulment), it might seem better to dispense with unwinding entirely. That said, if unwinding is viewed as an appropriate remedy, there is no reason to limit it in the ways that it is limited under current law. Unwinding relief along the lines available under the claim of right doctrine and the TBR would seem to do no more violence to the annual accounting principle or to tax administration more generally than it does in these areas. Thus, one would hope for both a narrowing of the rule that permits unwinds for rescissions no matter what the reason as long as the rescission occurs in the same taxable year, and relaxation of the rule that limits any unwind to the same taxable year. Any reversal, to merit unwind treatment, ought to be allowed only if the mistake or error giving rise to it is justified. When the error is justified, however, it does not seem that the same-year rule should limit the relief, though it might modify it. Thus, unwinding presumably could extend both to reversals that constitute modifications and to reversals in donative situations or other non-arm's-length arrangements under the income tax, such as tax elections;²⁷³ it would not be limited *a priori* to rescissions. The same-year rule might continue to have an effect, however, on the nature of the relief. Under this partly narrower and partly broader standard, a same-year reversal that merits unwind treatment could simply result in complete disregard of both transactions, as under current law. A later-year reversal meriting unwind

²⁷² For example, mistake of law might be thought to be an inappropriate basis on which to provide unwinding relief.

²⁷³ Note that modifications may involve both a reversal and the addition of new terms. Technically, the latter raises additional issues going beyond the narrow one of whether the tax law should credit the reversal as an unwind, including the substantive question of whether taxpayers should be allowed to enter into agreements retroactively and the administrative question of whether it is possible to distinguish appropriate "retroactive" changes from inappropriate ones. These issues have not been explicitly addressed here, but it would seem that the same basic analysis of excuse and detection would apply to such new terms as applies to the reversing transaction.

treatment could be treated much as a deduction under the claim of right doctrine or an inclusion under the TBR.

The observations developed here about unwinding also illuminate its relationship to other kinds of error and the remedies that the tax law has developed for them. Each of the errors discussed involves a type of inconsistency related to the nature of rational purposive action that is presumed to underlie the conduct of actors in the world. Disregarding administrative concerns, there does not appear to be any particular reason to disfavor unwinding as a remedy, given the availability of claim of right, the TBR, and equitable recoupment for excusable errors having to do with different aspects of rational action.

Diagram 1: Unwinding Decision Tree



